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Editor's Note: Applying *Harvard*
Victoria Prussen Spears 97

Affirmative Action in Lending: The Implications of the *Harvard* Decision on Financial Institutions
Nanci L. Weissgold and Melissa Sanchez Malpass 100

Lenders Lock Horns Amid Tightening Credit Environment
Solomon J. Noh, Alastair Goldrein, Thomas S. Kessler and John Veraja 105

The Interagency Community Reinvestment Act Final Rule
Randy Benjenk, Karen Solomon, Graves Lee and Emily Hooker 109

Federal Banking Agencies Issue Final Principles for Climate-Related Financial Risk Management
Robert C. Azarow, James P. Bergin, Amber A. Hay, Teresa L. Johnson,
Michael A. Mancusi, Erik Walsh and Michael Treves 119

Federal Deposit Insurance Corporation Proposes Large Bank-Like Corporate Governance and Risk Management Standards for FDIC-Supervised Depository Institutions With US$10 Billion or More in Assets
Richard M. Alexander, Robert C. Azarow, James P. Bergin, David F. Freeman, Jr.,
Amber A. Hay, Michael A. Mancusi, Kevin M. Toomey, Anthony Raglani,
Erik Walsh and Paul Lim 126

Consumer Financial Protection Bureau Proposes to Supervise Larger Participants in the Market for Digital Payment Applications
Valerie Hletko, Eric Mogilnicki, Michael Nonaka and Andrew Smith 133

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Les Jacobowitz, Brooke Fodor, Megan (Woodward) Daily,
Justin A. Kesselman, Alan S. Dubin, Matthew R. Bentley, and Malia K. Benison 137

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The Banking Law Journal
March 2024

Editor's Note
Applying *Harvard*

By Victoria Prussen Spears*

The U.S. Supreme Court's ruling last summer in *Students for Fair Admissions v. President and Fellow of Harvard College* effectively ended race-conscious admission programs at colleges and universities across the country. If you are wondering whether the impact of the Supreme Court holding could extend beyond education to lending and housing or whether it may serve to undercut federal regulators' legal theories for demonstrating redlining and present a challenge for special purpose credit programs that explicitly consider race or other protected characteristics, then read on.

And if you are interested in other banking and finance-related subjects, keep on reading!

IMPLICATIONS OF THE *HARVARD* DECISION

As I noted above, the first article in this issue of *The Banking Law Journal*, titled, "Affirmative Action in Lending: The Implications of the *Harvard* Decision on Financial Institutions," examines how the U.S. Supreme Court ruling ending race-based admissions at colleges and universities could change how federal regulators encourage lenders to consider race and ethnicity. The authors are Nanci L. Weissgold and Melissa Sanchez Malpass of Alston & Bird LLP.

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* Victoria Prussen Spears is a writer, editor and law firm marketing consultant for Meyerowitz Communications Inc. A graduate of Sarah Lawrence College and Brooklyn Law School, Ms. Spears was an attorney at a leading New York City law firm before joining Meyerowitz Communications. Ms. Spears, who is Editor of *The Banking Law Journal*, *Pratt's Journal of Bankruptcy Law*, *Pratt's Energy Law Report*, *Pratt's Government Contracting Law Report* and *Pratt's Privacy & Cybersecurity Law Report*, can be reached at vpspears@meyerowitzcommunications.com.

PARTICIPATING LENDERS

The next article, titled, "Lenders Lock Horns Amid Tightening Credit Environment," is by Solomon J. Noh, Alastair Goldrein, Thomas S. Kessler and John Veraja of Cleary Gottlieb Steen & Hamilton LLP.

In this piece, the authors discuss some of the specific ways in which the participating lenders of a company are able to take advantage of covenants or provisions of loan documents to benefit from transactions over the objections of non-participating lenders. The authors also explain the ways in which these transactions will likely have an impact on the market, and how this U.S. trend will see repercussions in Europe and the UK.

THE CRA

The article that follows is by Randy Benjenk, Karen Solomon, Graves Lee and Emily Hooker of Covington & Burling LLP. Titled, "The Interagency Community Reinvestment Act Final Rule," in this work the authors discuss the final rule from the federal banking agencies that overhauls the regulatory framework for evaluating banks' performance under the Community Reinvestment Act.

CLIMATE

Then, in "Federal Banking Agencies Issue Final Principles for Climate-Related Financial Risk Management," Robert C. Azarow, James P. Bergin, Amber A. Hay, Teresa L. Johnson, Michael A. Mancusi, Erik Walsh and Michael Treves of Arnold & Porter Kaye Scholer LLP provide an overview of the final principles for climate-related financial risks management for large financial institutions issued recently by the federal banking agencies.

THE FDIC

Richard M. Alexander, Robert C. Azarow, James P. Bergin, David F. Freeman, Jr., Amber A. Hay, Michael A. Mancusi, Kevin M. Toomey, Anthony Raglani, Erik Walsh and Paul Lim of Arnold & Porter Kaye Scholer LLP are the authors of "Federal Deposit Insurance Corporation Proposes Large Bank-Like Corporate Governance and Risk Management Standards for FDIC-Supervised Depository Institutions With US$10 Billion or More in Assets."

Here, the authors review a rule and guidelines proposed recently by the Federal Deposit Insurance Corporation relating to corporate governance and risk management standards.

THE CFPB

Next, in "Consumer Financial Protection Bureau Proposes to Supervise Larger Participants in the Market for Digital Payment Applications," Valerie

Hletko, Eric Mogilnicki, Michael Nonaka and Andrew Smith of Covington & Burling LLP discuss the Consumer Financial Protection Bureau's proposed rulemaking relating to digital payment applications.

PLEDGED ASSETS

Les Jacobowitz, Brooke Fodor, Megan (Woodward) Daily, Justin A. Kesselman, Alan S. Dubin, Matthew R. Bentley, and Malia K. Benison of ArentFox Schiff LLP are the authors of the article titled, "Avoiding Collateral Damage: Whose Pledged Assets Are They Anyway?" In this piece, the authors discuss the practice of repledging.

Enjoy the issue!

Affirmative Action in Lending: The Implications of the *Harvard* Decision on Financial Institutions

By Nanci L. Weissgold and Melissa Sanchez Malpass*

In this article, the authors examine how the U.S. Supreme Court ruling ending race-based admissions at colleges and universities could change how federal regulators encourage lenders to consider race and ethnicity.

The U.S. Supreme Court's ruling last summer in *Students for Fair Admissions v. President and Fellow of Harvard College*[1] effectively ended race-conscious admission programs at colleges and universities across the country. Specifically, the Supreme Court held that decisions made "on the basis of race" do nothing more than further "stereotypes that treat individuals as the product of their race, evaluating their thoughts and efforts – their very worth as citizens – according to a criterion barred to the Government by history and the Constitution."

In particular, the Supreme Court reasoned that "when a university admits students 'on the basis of race, it engages in the offensive and demeaning assumption that [students] of a particular race, because of their race, think alike.'" Such stereotyping purportedly only causes "continued hurt and injury," contrary as it is to the "core purpose" of the Equal Protection Clause. Ultimately, the Supreme Court reminded us that "ameliorating societal discrimination does not constitute a compelling interest that justifies race-based state action."

In the context of lending, federal regulatory agencies expect and encourage financial institutions to explicitly consider race in their lending activities. While the Community Reinvestment Act has required banks to affirmatively consider the needs of low-to-moderate-income neighborhoods, regulatory enforcement actions over the last few years have required both bank and nonbank mortgage lenders to explicitly consider an applicant's protected characteristics such as race and ethnicity – conduct plainly prohibited by fair lending laws.

Could the impact of the Supreme Court holding extend beyond education to lending and housing? Will the *Harvard* decision serve to undercut federal

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* The authors, attorneys with Alston & Bird LLP, may be contacted at nanci.weissgold@alston.com and melissa.malpass@alston.com, respectively.

[1] Students for Fair Admissions v. President and Fellow of Harvard College, No. 20–1199 (U.S. June 29, 2023).

regulators' legal theories for demonstrating redlining and present a challenge for special purpose credit programs that explicitly consider race or other protected characteristics?

FAIR LENDING LAWS PROHIBIT CONSIDERATION OF RACE

The Equal Credit Opportunity Act (ECOA) prohibits a creditor from discriminating against any applicant, in any aspect of a credit transaction, on the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract). Similarly, the Fair Housing Act prohibits discrimination against any person in making available a residential real-estate-related transaction, or in the terms or conditions of such a transaction, because of race, color, religion, sex, handicap, familial status, or national origin.

In March 2022,[2] the Consumer Financial Protection Bureau (CFPB) went as far as to update its Examination Manual to provide that unfair, deceptive, or abusive acts and practices (UDAAPs) "include discrimination" and signaled that the CFPB will examine whether companies are adequately "testing for" discrimination in their advertising, pricing, and other activities. When challenged by various trade organizations, the U.S. District Court for the Eastern District of Texas ruled that the CFPB's update exceeded the agency's authority under the Dodd-Frank Act. This decision is limited, however, and enjoins the CFPB from pursuing its theory against those financial institutions that are members of the trade association plaintiffs. It is also unclear if the verdict will be appealed by the CFPB.

Despite federal prohibitions, regulators such as the CFPB and the U.S. Department of Justice (DOJ) expect, and at times even require, lenders to affirmatively target their marketing and lending efforts to certain borrowers and communities based on race and/or ethnicity.

RACE-BASED DECISIONS ARE ENCOURAGED AND EVEN REQUIRED BY REGULATORS

CFPB examiners often ask lenders to describe their affirmative, specialized efforts to target their lending to minority communities. If there have been no such explicit efforts by the institution, the CFPB penalizes these lenders for not explicitly considering race in their marketing and lending decisions. For example, in the CFPB's redlining complaint[3] against Townstone Financial, the

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[2] https://www.consumerfinance.gov/about-us/newsroom/cfpb-targets-unfair-discrimination-in-consumer-finance/.

[3] https://files.consumerfinance.gov/f/documents/cfpb_townstone-financial_complaint_2020-07.pdf.

CFPB alleged that "Townstone made no effort to market directly to African-Americans during the relevant period," and that "Townstone has not specifically targeted any marketing toward African-Americans."

What's more, if enforcement culminates in a consent order, the CFPB and DOJ effectively impose race-based action by requiring lenders to fund loan subsidies or discounts that will be offered exclusively to consumers based on the predominant race or ethnicity of their neighborhood. In the CFPB/DOJ settlement with nonbank Trident Mortgage,[4] the lender was required to set aside over $18 million toward offering residents of majority-minority neighborhoods "home mortgage loans on a more affordable basis than otherwise available."

And in the more recent DOJ settlement with Washington Trust,[5] the consent order required the lender to subsidize only those mortgage loans made to "qualified applicants," defined in the settlement as consumers who either reside, or apply for a mortgage for a residential property located, in a majority-Black and Hispanic census tract. Such subsidies are a common feature of recent redlining settlements, which have been occurring with increased frequency since the DOJ announced its Combating Redlining Initiative in October 2021.[6]

Not only do the CFPB and DOJ encourage, and in certain cases, even require, race-based lending in potential contravention of fair lending laws, but federal regulators also expect some degree of race-based hiring by lenders. This expectation is based on the stereotypical assumption that lenders need racial and ethnic minorities in their consumer-facing workforce to attract racial and ethnic minority loan applicants. In the *Townstone* complaint, for example, the CFPB chastised the lender for failing to "employ an African-American loan officer during the relevant period, even though it was aware that hiring a loan officer from a particular racial or ethnic group could increase the number of applications from members of that racial or ethnic group."

Ultimately, all the recent redlining consent orders announced by the CFPB and DOJ impose at least some race-based requirement, which would seem to run afoul of fair lending laws and Supreme Court precedent.

RACIAL QUOTA-BASED METRICS USED BY REGULATORS

Further, when assessing whether a lender may have engaged in redlining against a particular racial or ethnic group, the CFPB and DOJ, as a matter of

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[4] https://files.consumerfinance.gov/f/documents/cfpb_trident-consent-order_2022-09.pdf.

[5] https://www.justice.gov/d9/2023-09/washington_trust_consent_order.pdf.

[6] https://www.justice.gov/opa/pr/justice-department-announces-new-initiative-combat-redlining.

course, employ quota-based metrics to evaluate the "rates" or "percentages" of a lender's activity in majority-minority geographic areas, specifically majority-minority census tracts (MMCTs). Then the regulators compare such rates or percentages of the lender's loan applications or originations in MMCTs to those of other lenders. For example, in its complaint against Lakeland Bank,[7] the DOJ focused on the alleged "disparity between the rate of applications generated by Lakeland and the *rate* generated by its peer lenders from majority-Black and Hispanic areas." The agency criticized the bank's "shortfalls in applications from individuals identifying as Black or Hispanic compared to the local demographics and aggregate HMDA averages."

Undoubtedly, this approach utilizes nothing more than a quota-based metric, which the Supreme Court in *Harvard* squarely rejected. Indeed, the Supreme Court reasoned that race-based programs amount to little more than determining how "the breakdown of the [incoming] class compares to the prior year in terms of racial identities," or comparing the racial makeup of the incoming class to the general population, to see whether some proportional goal or benchmark has been reached.

While the goal of meaningful representation and diversity is commendable, the Supreme Court emphasized that "outright racial balancing and quota systems remain patently unconstitutional." And such a focus on racial quotas means that lenders could attempt to minimize or even eliminate their fair lending risk simply by decreasing their lending in majority-non-Hispanic-White neighborhoods – without ever increasing their loan applications or originations in majority-minority neighborhoods. Of course, this frustrates the essential purpose of ECOA and other fair lending laws.

POTENTIAL CONSTITUTIONAL SCRUTINY OF RACE-BASED LENDING EFFORTS

If race-based state action, including the use of racial quotas, violates the Equal Protection Clause, it is possible that the race-based lending measures recently encouraged and even required by federal regulators may be constitutionally problematic.

In addition to racially targeted loan subsidies and racially motivated loan officer hiring, regulators continue to encourage lenders[8] to implement special purpose credit programs (SPCPs) to meet the credit needs of specific racial or ethnic groups. As the CFPB noted in its advisory opinion, "[b]y permitting the

[7] https://www.justice.gov/media/1249471/dl?inline.

[8] https://files.consumerfinance.gov/f/documents/cfpb_spcp_interagency-statement_2022-02.pdf.

consideration of a prohibited basis such as race, national origin, or sex in connection with a special purpose credit program, Congress protected a broad array of programs 'specifically designed to prefer members of economically disadvantaged classes' and 'to increase access to the credit market by persons previously foreclosed from it.'"[9]

While SPCPs are explicitly permitted by the language of ECOA and its implementing regulation, Regulation B, as an exception to the statute's mandate against considering a credit applicant's protected characteristics, it is uncertain whether these provisions, if challenged, would survive constitutional scrutiny by the current Supreme Court.

TAKEAWAYS FOR LENDERS

For the time being, lenders that offer SPCPs based on a protected characteristic should ensure that their written plans continue to meet the requirements of Section 1002.8(a)(3). As always, the justifications for lending decisions that could disproportionately affect consumers based on their race, ethnicity, or other protected characteristic should be well documented and justified by legitimate business needs. And if faced with a fair lending investigation or potential enforcement action, lenders should consider presenting to regulators any alternate data findings or conclusions that demonstrate the institution's record of lending in MMCTs rather than focusing on the rates or percentages of other lenders in the geographic area.

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[9] https://www.federalregister.gov/documents/2021/01/15/2020-28596/equal-credit-opportunity-regulation-b-special-purpose-credit-programs.

Lenders Lock Horns Amid Tightening Credit Environment

By Solomon J. Noh, Alastair Goldrein, Thomas S. Kessler and John Veraja[*]

In this article, the authors discuss some of the specific ways in which the participating lenders of a company are able to take advantage of covenants or provisions of loan documents to benefit from transactions over the objections of non-participating lenders. The authors also explain the ways in which these transactions will likely have an impact on the market, and how this U.S. trend will see repercussions in Europe and the UK.

Liability management exercises, sometimes called "position enhancing transactions" or, more colorfully, "lender-on-lender violence" is a relatively recent restructuring phenomenon in the United States. The trend presents itself in different restructurings, each with a slightly different flavor. The overall theme, however, is the same. These transactions involve groups of lenders coordinating with the company to modify the company's debt structure and provide new money. These transactions benefit those lenders which decide to participate, while excluding certain other investors from the benefits of the transaction. Litigation often ensues.

This article discusses some of the specific ways in which the participating lenders of a company are able to take advantage of covenants or provisions of loan documents to benefit from transactions over the objections of non-participating lenders. This article also explains the ways in which these transactions will likely have an impact on the market, and how this U.S. trend will see repercussions in Europe and the UK.

"UP-TIER" AND "DROP-DOWN" TRANSACTIONS

"Up-tier" and "drop-down" transactions are two examples of transactions where lenders that hold pari-passu debt, and share recoveries on a pro-rata basis, can be prejudiced by agreements between the borrower and a subset of the lenders in the same class. The borrower in such cases works alongside a subset of the lenders to amend the underlying credit documentation, permitting preferential treatment of this subset of lenders to the prejudice of lenders who are not a part of the participating group. This trend was initially well publicized in the restructuring of Serta Simmons,[1] as well as Boardriders[2] and more recently in Envision and Wesco Incora.

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[*] The authors, attorneys with Cleary Gottlieb Steen & Hamilton LLP, may be contacted at sjnoh@cgsh.com, agoldrein@cgsh.com, tkessler@cgsh.com and jveraja@cgsh.com, respectively.

[1] https://www.privatedebtinvestor.com/creditor-on-creditor-violence-over-serta-simmons/.

Some of the main questions relate to the specific ways in which the participating lenders of a company are able to take advantage of covenants or provisions of loan documents that allow them to do this over the objections of non-participating lenders. How are companies able to issue new debt and prime existing lenders, or take collateral that was attached to existing debt to use as part of a new transaction?

This could happen in the form of "up-tier" transactions, which require amendments to existing credit documentation, and often lead to litigation. Typically, in exchange for the agreement between the subset of lenders and the borrower – which allows the company to amend the documentation and provide it with greater flexibility – the lenders that agree to the amendments are allowed to provide additional super-senior financing. In addition, a portion of such lenders' existing loans are typically rolled up into this super-senior tranche. As minority lenders are "primed" without their consent, this creates two classes of creditors from the single group of lenders that were originally ranked pari-passu. Often those lenders left outside of these agreements are faced with the prospect of diminished recovery and, in certain situations, little to no recovery.

A second form of "lender on lender violence" are "drop-down" transactions, whereby the company, working within the confines of its existing debt documentation (using permissive investment and asset sale baskets), contributes certain assets to entities outside the credit support group such as an unrestricted subsidiary. This enables that subsidiary to incur financing that is structurally senior to the other debt, allowing the company to extend its runway while also benefiting from a liquidity injection. Majority creditors have recourse to the "dropped down" assets, thus eliminating the risk that their recoveries are diluted by minority creditors. This type of drop-down financing was most notably seen in the restructuring of J. Crew.

BANKRUPTCY COURTS BEGIN TO WEIGH IN

It should come as no surprise that these transactions give rise to litigation, including in bankruptcy courts when borrowers are not able to stave off financial distress. In recent years, The Southern District of Texas has become a bankruptcy filing hotspot. 2023 is no exception, with the district seeing the highest number of corporate Chapter 11 filings in the country.

It is particularly noteworthy then, that the U.S. Bankruptcy Court for the Southern District of Texas issued a decision in the Serta Simmons bankruptcy

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[2] https://globalrestructuringreview.com/article/all-eyes-creditor-creditor-violence-after-boardriders-tiering-decision.

upholding Serta's liability management transaction, holding that the transaction was permitted by the terms of the relevant debt and not conducted in bad faith. The decision appeared to be motivated by a view that sophisticated investors should bear responsibility for assessing what creative transactions might be permissible under governing documents, and that companies should have latitude to take advantage of perceived "gaps" in covenants. Notably, the bankruptcy court's decision reached an opposite conclusion from a U.S. District Court judge in New York, who refused to dismiss a complaint filed by non-participating creditors prior to Serta's bankruptcy. The court's decision will not be the last word; non-participating creditors in the Serta case have appealed.

It remains to be seen how other courts will interpret these issues, but companies will likely continue to seek out favorable benches. The facts will be different in each case, and perhaps by showing bad-faith arrangements a decision will be different. As a general rule, however, bankruptcy judges may be more inclined to make a decision that would allow for a debtor's restructuring, as opposed to a non-bankruptcy judge who may take a less flexible or reorganization-minded approach.

MIGRATION TO EUROPE AND THE UK

This is an evolving area of the law, with many decisions that are still pending. And while lender-on-lender violence has not been as pervasive in the UK and Europe yet, there is an expectation that it will become a more common trend – not least because many of the private equity companies involved in U.S. restructurings are also involved in situations in these other jurisdictions.

Already, some of these issues are playing out in Europe. Greek gaming company Intralot, for example,[3] restructured in 2021 and saw some of the same tactics used by lenders discussed above.

However, there are certain restraining factors from a European perspective including:

- If the existing financing arrangements involve an intercreditor agreement, an amendment to the intercreditor ranking with respect to collateral which was not otherwise contemplated in the original financing would require all lender consent (thereby requiring an English scheme of arrangement or restructuring plan); and
- Exit consents are commonly used in exchange offers; but where the relevant debt is English law governed, market participants have been

[3] https://www.lexology.com/library/detail.aspx?g=3e28e1d7-32ca-4220-af76-857c24a478bd#:~:text=It%20is%20a%20publicly%20listed,with%20shares%20of%20a%20subsidiary.

careful to limit to the scope of the exit consent terms in light of a past English court decision that admonished against aggressive tactics used in that regard.

So how does this emerging trend fit into the bigger restructuring picture? In light of higher interest rates and higher borrowing rates amid a tighter credit environment, issuers are going to look for more creative solutions to buy themselves time. Companies are going to continue to scrutinize opportunities to take advantage of existing covenant packages and raise additional financing.

At the same time, there also has been a tightening of covenants and an increase in thresholds for various actions. For example, the ability for borrowers to issue new notes under an existing indenture is becoming more limited, as are opportunities related to lien stripping. Because consent rates are increasing in bond and loan documents, investors will likely need to exercise greater caution with respect to having a strong relationship with a super-majority of lenders, in order to minimize the risk of minority lenders having hold-out value over the majority.

In light of the recent credit environment, companies are likely to continue to face difficulties in terms of restructuring their existing debt obligations. Creative solutions such as "up-tier" and "drop-down" transactions, and the spill-over effects of these approaches, will likely continue to engender litigation between lenders, though it remains to be seen how insolvencies across the pond will differ from those in the United States.

The Interagency Community Reinvestment Act Final Rule

By Randy Benjenk, Karen Solomon, Graves Lee and Emily Hooker*

In this article, the authors discuss the final rule from the federal banking agencies that overhauls the regulatory framework for evaluating banks' performance under the Community Reinvestment Act.

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the agencies) have released a final rule[1] to overhaul the agencies' regulatory framework for evaluating banks' performance under the Community Reinvestment Act (CRA). The final rule concludes a rulemaking process stretching back more than five years, following a 2022 interagency notice of proposed rulemaking (the proposal)[2] and an earlier, abandoned effort by the OCC to make changes to its own CRA rule. The final rule makes the most significant interagency changes to the agencies' CRA regulations in more than 25 years, and will substantially alter CRA compliance obligations for banks of varying sizes and business models.

This article provides key takeaways for large banks, which the final rule defines as banks with $2 billion or more in assets.

MOST PROVISIONS OF THE FINAL RULE WILL BECOME OPERATIVE AT THE BEGINNING OF 2026

While the final rule becomes effective on April 1, 2024, a large bank will need to comply with most of the final rule's operative provisions – including assessment area requirements and performance tests – beginning January 1, 2026. Data reporting under the final rule will begin in early 2027. The proposal would have provided just a year for compliance with most of its key requirements, which prompted substantial pushback from commenters.

NEW GEOGRAPHIES WILL BE SUBJECT TO EVALUATION, CREATING CHALLENGES AND OPPORTUNITIES

Under the final rule, a large bank could be required to delineate two types of assessment areas in which its CRA evaluation will be focused:

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* The authors, attorneys with Covington & Burling LLP, may be contacted at rbenjenk@cov.com, ksolomon@cov.com, glee@cov.com and ehooker@cov.com, respectively.

[1] https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-cra-20231024.pdf.

[2] https://www.federalregister.gov/documents/2022/06/03/2022-10111/community-reinvestment-act.

- A bank must delineate "facility-based assessment areas" encompassing any Metropolitan Statistical Area, one or more contiguous counties within an MSA, or one or more contiguous counties within the nonmetropolitan area of a state in which the bank maintains a main office, branch, or other staffed or deposit-taking remote service facility, as well as surrounding geographies in which the bank has originated or purchased a substantial portion of loans. Facility-based assessment areas are generally the same as assessment areas under the existing CRA regulations, except that the minimum size of a facility-based assessment area has increased to be at the county level.
- Solely for purposes of the Retail Lending Test (described below), a bank may also be required to delineate "retail lending assessment areas" encompassing (1) any metropolitan statistical area, excluding counties already included within a facility-based assessment area, or an aggregation of all of the nonmetropolitan areas in a single state, excluding counties already in a facility-based assessment area or in which the bank did not originate any closed-end home mortgage loans or small business loans that year, in which (2) the bank originated at least 150 closed-end home mortgage loans or 400 small business loans for two consecutive calendar years. The final rule increased these loan origination thresholds from those contained in the proposal.

The final rule contains a key carve-out to the retail lending assessment area framework. A large bank that conducts 80 percent or more of specified retail lending activity (which for most banks will be home mortgage loans, small business loans, small farm loans, and multifamily loans) within its facility-based assessment areas over a two-year period is exempt from the requirement to delineate retail lending assessment areas the following year. This carve-out is likely to apply to large banks with robust branch networks.

The Retail Lending Test will also evaluate any large bank's retail lending distribution in an "outside retail lending area," meaning the residual nationwide area where the bank originated or purchased covered loans outside of its facility-based assessment areas and retail lending assessment areas. If a large bank originates or purchases even a single closed-end home mortgage, small business, or small farm loan (or automobile loan if majority automobile lender) in the outside retail lending area during the evaluation period, there is no carve-out to the outside retail lending area requirement.

While the new geographies subject to evaluation in the Retail Lending Test could create pitfalls for large banks, the final rule also creates greater opportunities for large banks to receive favorable consideration for community development activities conducted outside their facility-based assessment areas.

THE FINAL RULE LARGELY MAINTAINS THE PROPOSED LARGE BANK EVALUATION FRAMEWORK, WITH SOME SIMPLIFICATIONS AND TWEAKS

Like the proposal, the final rule sets forth four performance tests to which large banks will be subject. Each test contains a number of sub-tests, which could easily produce dozens of scores, conclusions, and ratings of different facets of a bank's performance across various geographies.

Test 1: Retail Lending Test

The Retail Lending Test evaluates whether the retail lending activities of the bank meet the needs of low- and moderate-income (LMI) individuals, small businesses, and small farms, and individuals and businesses in LMI census tracts. Under the final rule, the Retail Lending Test focuses on the distribution of a bank's closed-end home mortgage loans, small business loans, and small farm loans, as well as automobile loans if automobile lending makes up a majority of the bank's retail lending activity (or if the bank elects to have automobile lending included). This product focus departs from the proposal, which would have also included open-end home mortgage loans and multifamily loans, and would have included automobile loans for all banks.

The Retail Lending Test begins with a retail lending screen that assesses a bank's volume of retail lending (including originations and purchases) relative to its deposit base in each facility-based assessment area. If a bank's ratio falls below 30% of the market ratio, the bank is only eligible for a "Needs to Improve" or "Substantial Noncompliance" conclusion in the assessment area unless certain contextual factors explain the shortfall. The numerator of the retail lending screen includes open-end home mortgages and multifamily loans in addition to the products evaluated in the Retail Lending Test's distribution analysis (i.e., closed-end home mortgages and small business and small farm loans for most banks).

The Retail Lending Test primarily evaluates the distribution of a bank's loans in its assessment areas, and the outside retail lending area, within the retail lending categories that constitute "major product lines" for the bank within the geography. In a facility-based assessment area and the outside retail lending area, a "major product line" is any of the four categories of retail loans (closed-end home mortgages, small business loans, small farm loans, and, for majority-auto lenders, automobile loans) that comprises 15 percent or more of the bank's total lending in those product lines, by a combination of dollar amount and loan count, in that area. In a retail lending assessment area, a major product line is whichever product (closed-end home mortgages, small business loans, or both) triggers the relevant threshold to create the retail lending assessment area.

The distribution of a bank's loans in major product lines in a given area is generally evaluated across two dimensions: (1) a "geographic distribution" metric that evaluates the bank's proportion of originated and purchased loans to borrowers located in LMI census tracts in the area, and (2) a "borrower distribution" metric that evaluates the bank's proportion of originated and purchased loans that are to LMI borrowers, or to the smallest small businesses or small farms in the area overall, regardless of geography. For both metrics, the bank's performance is compared to (A) the comparable proportion reported by all reporting lenders in the area in a "market benchmark" and (B) local demographics in a "community benchmark."

Based on commenters' feedback, the agencies adjusted the standards for retail lending performance to make "Low Satisfactory," "High Satisfactory," and "Outstanding" conclusions on the test modestly more achievable than under the proposal.

Test 2: Retail Services and Products Test

The Retail Services and Products Test uses predominantly qualitative means, informed by quantitative metrics, to evaluate the availability and responsiveness of a bank's (a) retail banking services and (b) retail banking products.

The first Retail Services and Products sub-test, addressing the bank's retail banking services, considers:

(1) Branch availability and services;

(2) Remote service facilities; and

(3) Digital and other delivery systems.

First, the branch availability and services evaluation compares the distribution of a bank's branches in LMI census tracts to community and market benchmarks, with examiners retaining discretion about how to use that data to produce a conclusion. Examiners will evaluate a bank's record of opening and closing branches in LMI census tracts. Branches in certain underserved areas – i.e., branches in middle- and upper-income census tracts that serve LMI consumers, branches in distressed and underserved nonmetropolitan middle-income census tracts, and branches in Native Land Areas – will be considered favorably. Examiners will also evaluate hours of operation and services offered at branches in LMI census tracts as compared to other branches.

Second, the availability of remote service facilities (including ATMs) in a given facility-based assessment area is compared to community benchmarks based on income demographics. As compared to the proposal, the final rule permits additional consideration of remote service facilities in middle- and upper-income census tracts that serve LMI consumers, distressed or underserved nonmetropolitan middle-income census tracts, and Native Land Areas.

Third, for a large bank with more than $10 billion in assets, or a smaller large bank that does not operate through branches, digital and other delivery systems are evaluated at the institution level based on:

(i) Digital and other delivery system activity by individuals in LMI census tracts compared to that of middle- and upper-income census tracts, including usage and account openings;

(ii) The range of retail banking services and retail banking products offered through digital and other delivery systems; and

(iii) The bank's strategy and initiatives to serve LMI individuals through such systems.

The second Retail Products and Services sub-test evaluates the responsiveness of the bank's retail banking products, i.e., credit products and programs, and, for banks with more than $10 billion in assets, deposit products. In a change to the proposal, the final rule provides that this sub-test can only benefit a bank's conclusion.

Credit products and programs offered to LMI individuals, residents of LMI census tracts, and small businesses and small farms will be considered on a qualitative basis. Products such as low-cost education loans and loans offered through special purpose credit programs will receive favorable consideration.

Deposit products will be evaluated based on the availability and usage of such products that are responsive to LMI consumers' needs. To evaluate availability, examiners will consider the extent to which a bank offers deposit products with:

(i) Low-cost features, such as deposit products with no overdraft or insufficient funds fees, no low or minimum balance requirements, no or low monthly maintenance fees, or free or low-cost checking and bill payment services;

(ii) Features that facilitate broad functionality and accessibility, such as deposit products with in-network ATM access, debit cards for point-of-sale and bill payments, and immediate access to funds for customers cashing payroll, government, or bank-issued checks; or

(iii) Features that facilitate inclusive access by people without banking or credit histories or with adverse banking histories.

To evaluate usage, examiners will consider the number of responsive deposit accounts opened and closed in census tracts of differing income levels; the percentage of a bank's responsive deposit accounts compared to its total deposit accounts; marketing, partnerships, and other activities by the bank to promote awareness and use of responsive deposit accounts; and any other relevant bank-provided information.

Test 3: Community Development Financing Test

The Community Development Financing Test evaluates whether a bank meets community development financing needs in its facility-based assessment areas and elsewhere through community development loans and community development investments. Examiners will review the ratio of the dollar value of the bank's community development loans and community development investments to the bank's annual dollar volume of deposits, and compare that ratio to market benchmarks both locally and nationwide. The final rule leaves to examiner discretion how well a bank would need to do relative to the benchmarks to attain a particular conclusion on the test.

Examiners will also conduct a review of community development loans and community development investments to decide how impactful and responsive they are, drawing on an enumerated list of impact and responsiveness factors as well as any other performance context information. The enumerated impact and responsiveness factors include consideration of community development activities that serve areas with high or persistent poverty, activities that support minority depository institutions, women's depository institutions, low-income credit unions, or community development financial institutions; or are investments in projects financed with federal low-income housing tax credits or new markets tax credits.

The final rule adds to the proposed framework a Bank Nationwide Community Development Investment Metric for banks with more than $10 billion in assets. This metric measures the dollar volume of the bank's community development investments (excluding mortgage-backed securities) that benefit or serve all or part of the nationwide area, compared to the bank's nationwide deposits. Comparing the metric to a market benchmark can only contribute positively to the bank's overall Community Development Financing Test conclusion.

Test 4: Community Development Services Test

The Community Development Services Test reviews the extent to which a bank provides community development services and the impact and responsiveness of those services in satisfying community development needs. The test may incorporate certain quantitative metrics, such as:

(i) A bank's number of community development services attributable to each type of community development;

(ii) The capacities in which the board members or employees of a bank or its affiliates serve;

(iii) The total hours of community development services performed by

the bank; and

(iv) Other evidence that services are responsive to community development needs.

However, the test may also consider qualitative review of the impact and responsiveness of the community development services that benefit or serve the area. The agencies declined to adopt from the proposal a metric that would have measured the average number of community development service hours per full-time equivalent employee for a bank with more than $10 billion in assets.

As under the existing CRA regulations, community development services must pertain to the provision of financial services or the expertise of bank personnel. The agencies proposed loosening this requirement in nonmetropolitan (i.e., rural) areas, but ultimately did not adopt the change in the final rule.

An Institution-Level Performance Score

The four tests described above combine into a single overall institution-level performance score, with a weighting of 40 percent for the Retail Lending Test, 10 percent for the Retail Services and Products Test, 40 percent for the Community Development Financing Test, and 10 percent for the Community Development Services Test. This approach of weighting the retail-focused tests equally with the community development-focused tests departs from the weighting outlined in the proposal, which would have assigned more weight to the retail-focused tests.

Additionally, a large bank needs to receive at least a Low Satisfactory conclusion on the Retail Lending Test to receive a Satisfactory overall rating. A large bank with 10 or more assessment areas also must receive at least a Low Satisfactory conclusion in 60 percent of its assessment areas (by number) in order to receive a Satisfactory rating overall.

As is the case in the current CRA regulations, examiners could downgrade a bank's rating based on evidence of discriminatory or other illegal credit practices. The agencies had proposed to broaden this standard to consider discriminatory or other illegal practices unrelated to credit, but backed away from this change in the final rule.

The bank's final, institution-level rating can be "Outstanding," "Satisfactory," "Needs to Improve," or "Substantial Noncompliance," consistent with the existing CRA regulations.

THE FINAL RULE CLARIFIES AND TAILORS THE ACTIVITIES THAT RECEIVE CREDIT AS COMMUNITY DEVELOPMENT ACTIVITIES

The final rule provides that the agencies will establish and maintain a public, illustrative, and non-exhaustive list of qualifying community development

activities eligible for CRA credit. Additionally, a bank will be able to request from the agencies an advance determination that its activities qualify and should go on the list. The final rule also sets forth 11 community development purposes that warrant credit under the two Community Development tests. An activity generally is required to meet: a majority standard, generally meaning that a majority of the beneficiaries of an activity are LMI; bona fide intent standard, generally meaning that if the beneficiaries are not quantifiable, the bona fide intent of the activity is qualifying community development; involve a minority depository institution, women's depository institution, low-income credit union, or community development financial institution; or involve a low-income housing tax credit. However, some activities related to affordable housing that do not meet a majority standard or the other available standards could receive partial credit in proportion to the percentage of affordable housing units.

Notable examples of activities that would qualify as community development in the final rule include:

- Affordable housing, including through purchases of mortgage-backed securities;
- Disaster preparedness and weather resiliency;
- Financial literacy initiatives;
- Activities in Native Land Areas;
- Partnerships with minority depository institutions, women's depository institutions, low-income credit unions, and community development financial institutions; and
- Economic development activities in conjunction with or syndication with government programs, including direct small business loans meeting a size and purpose test.

Compared to the proposal, the final rule includes two notable changes.

First, the proposal would have provided that, for a housing initiative to be considered "affordable," rents generally could not exceed 30 percent of 60 percent of the area median income. In the final rule, the agencies loosened this criterion to be 30 percent of 80 percent of area median income.

Second, the final rule permits direct loans to small businesses to count as an economic development activity where "size" and "purpose" tests are satisfied. However, unlike under the existing CRA regulations, the loan must be "in conjunction or in syndication with" a government program. The preamble to the final rule suggests that an SBA 7(a) loan would qualify for credit if the size and purpose test are satisfied.

THE WHOLESALE AND LIMITED PURPOSE DESIGNATIONS HAVE BEEN CONSOLIDATED INTO A SINGLE LIMITED PURPOSE BANK DESIGNATION, AND THESE BANKS ARE SUBJECT TO EVALUATION BASED ON COMMUNITY DEVELOPMENT FINANCING ACTIVITIES WITH OPTIONAL CONSIDERATION OF COMMUNITY DEVELOPMENT SERVICES

The existing CRA regulations provide that "limited purpose" banks and "wholesale" banks can be evaluated under a tailored framework that focuses on community development activities. Under the final rule, the agencies combined the two designations into a single "limited purpose" bank designation, which is available to a "bank that is not in the business of extending closed-end home mortgage loans, small business loans, small farm loans, or automobile loans evaluated under [the Retail Lending Test] to retail customers, except on an incidental and accommodation basis, and for which a designation as a limited purpose bank is in effect." Existing limited purpose banks and wholesale banks are not required to re-apply for the designation. The final rule subjects limited purpose banks to a modified version of the Community Development Financing Test and, at the bank's option, an evaluation of community development services.

STRATEGIC PLANS REMAIN AN OPTION, WITH MORE CLARITY THAN UNDER THE PROPOSAL

Like the existing CRA regulations and the proposal, the final rule permits a bank to elect to be evaluated under a strategic plan in lieu of the generally applicable performance tests. Banks operating under a strategic plan could deviate from the four performance tests in certain respects, if justified, and the final rule is more explicit than the proposal regarding the ways in which these banks can depart from the generally applicable standards. For example, strategic plan banks may use alternative weighting of the four tests or component geographic scores. However, as is the case under the existing CRA regulations, the flexibility afforded to strategic plans comes with costs. A bank must consult with members of its communities when developing its plan, make its draft plan available for public comment, and obtain prior regulatory approval of the plan.

ONEROUS NEW DATA COLLECTION REQUIREMENTS APPLY TO LARGE BANKS, PARTICULARLY THOSE WITH MORE THAN $10 BILLION IN ASSETS

The final rule requires large banks to collect substantial data concerning deposits, retail loans, and community development activities, which will be used to evaluate performance in the quantitative parts of the final rule's four tests. A large bank with more than $10 billion in assets is required to collect the most granular data, including the county of each depositor, which determines

the bank's deposit base in each assessment area and the outside retail lending area and thereby influences the bank's CRA obligation in each area. Large banks with no more than $10 billion in assets could instead rely on the FDIC's existing Summary of Deposits data, which report the branches in which banks book their deposits, to determine their CRA obligations.

Banks operating under a strategic plan are subject to the same data collection and reporting standards as their size would dictate if they were evaluated under the generally applicable performance tests. Limited purpose banks are also subject to large bank data collection reporting requirements for community development loans and investments.

THE AGENCIES PLAN TO LEVERAGE SMALL BUSINESS LENDING DATA GATHERED UNDER THE CFPB'S SECTION 1071 FINAL RULE, IF AND WHEN THAT DATA BECOMES AVAILABLE

The Consumer Financial Protection Bureau's final rule[3] to implement Section 1071 of the Dodd-Frank Act requires covered financial institutions to collect and report to the CFPB data on applications for credit for small businesses, including small farms.

While the agencies had planned to use the Section 1071 definition of a "small business loan" and Section 1071 data in the CRA rules, the Section 1071 rule has been the subject of court challenges, and in October 2023 a district court issued a nationwide injunction halting its implementation. The CRA final rule's text therefore omits references to the Section 1071 rule. Instead, the CRA final rule maintains the definition of small business loan provided in the existing CRA regulations, which, consistent with the call report definition of loan to small business, includes any loan of $1 million or less to a business. The final rule also contains independent data collection requirements for small business loans.

The preamble to the final rule indicates that the agencies plan to amend the CRA regulations to transition to the Section 1071 definition of a small business loan and Section 1071 data after they become available. Under the Section 1071 rule, a small business loan is an extension of business credit to a small business – which is generally a business with gross annual revenue of $5 million or less – other than trade credit, HMDA-reportable transactions, insurance premium financing, public utilities credit, securities credit, or incidental credit, without any loan amount threshold.

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[3] https://www.consumerfinance.gov/rules-policy/final-rules/small-business-lending-under-the-equal-credit-opportunity-act-regulation-b/.

Federal Banking Agencies Issue Final Principles for Climate-Related Financial Risk Management

By Robert C. Azarow, James P. Bergin, Amber A. Hay, Teresa L. Johnson, Michael A. Mancusi, Erik Walsh and Michael Treves*

In this article, the authors provide an overview of the final principles for climate-related financial risks management for large financial institutions issued recently by the federal banking agencies.

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the FBAs) have issued final interagency "Principles for Climate-Related Financial Risk Management for Large Financial Institutions" (the Principles).[1] Notably, after the Principles were proposed in 2021 and 2022, the FBAs received industry comments and criticisms from politicians – and even certain Federal Reserve Governors – about the burden in adopting these Principles and the perception that the FBAs were acting beyond their mandate, effectively as "climate policymakers."

This article provides an overview of the final Principles, changes from the draft Principles, and notable criticisms that reflect the ongoing debate about the role of the FBAs in influencing financial institutions' climate-related risk appetites and risk management practices.

The final Principles remain largely the same as the draft Principles. This is a strong message from the FBAs that they expect large financial institutions to adopt risk-based, climate-related financial risk management procedures. Although the Principles only apply to financial institutions with over US$100 billion in consolidated assets, it is possible that, formally or informally, these Principles eventually will form the basis of supervisory expectations for financial institutions of all sizes, and therefore these Principles should be of interest to the entire industry.

FINAL CLIMATE-RELATED RISK MANAGEMENT PRINCIPLES

The final Principles reiterate the FBAs' view that financial institutions are likely to be affected by both the physical risks and transition risks associated

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* The authors, attorneys with Arnold & Porter Kaye Scholer LLP, may be contacted at robert.azarow@arnoldporter.com, james.bergin@arnoldporter.com, amber.hay@arnoldporter.com, teresa.johnson@arnoldporter.com, michael.mancusi@arnoldporter.com, erik.walsh@arnoldporter.com and michael.treves@arnoldporter.com, respectively.

[1] https://www.govinfo.gov/content/pkg/FR-2023-10-30/pdf/2023-23844.pdf.

with climate change, which can manifest as traditional micro-prudential risks, such as credit, market, liquidity, operational, and legal risks. To address these risks, the Principles cover six areas: governance; policies, procedures and limits; strategic planning; risk management; data, risk management and reporting; and scenario analysis. The Principles also include a section on "management of risk areas," which describes how climate-related financial risk can be addressed in various traditional risk categories.

GOVERNANCE

- The Principles provide that financial institution boards of directors and management should demonstrate sufficient knowledge of the effects of climate-related financial risks on the institution and its risk profile.
- The FBAs expect the board:
    - To oversee the institution's risk-taking activities;
    - To hold management accountable for adhering to the risk management framework; and
    - To allocate appropriate resources to support climate-related financial risk management.
- Management should:
    - Provide the board with sufficient information for the board to make sound, well-informed decisions relating to material climate-related financial risks to the institution;
    - Implement the institution's policies in accordance with the board's strategic direction; and
    - Execute the institution's overall strategic plan and risk management framework, including overseeing the development and implementation of process to identify and manage material climate-related financial risk.

POLICIES, PROCEDURES AND LIMITS

- Management should incorporate material climate-related financial risks into policies, procedures, and limits to provide detailed guidance on the financial institution's approach to these risks in line with the strategy and risk appetite set by the board.
- The Principles establish that policies, procedures, and limits should be modified to reflect the distinctive characteristics of climate-related financial risks and changes to the financial institution's operating environment or activities.

STRATEGIC PLANNING

- The board should take into account material climate-related financial risk exposures when setting and monitoring the institution's overall business strategy and risk appetite.
- The board also should consider climate-related financial risk when overseeing management's implementation of capital plans, and it should assess the potential impact of material climate-related financial risk exposures on the institution's financial condition, operations, and business objectives over various time horizons.
- A financial institution should consider the impact of its climate-related risk management practices on low- and moderate-income (LMI) and other underserved communities and their access to financial products and services, consistent with the institution's obligations under applicable consumer protection laws.
- Institutions that publicly communicate their climate-related strategies should ensure that any public statements about strategies and commitments are consistent with the institution's internal strategies, risk appetite statements, and risk management framework.

RISK MANAGEMENT

- Management should oversee the development and implementation of processes to identify, measure, monitor, and control exposures to climate-related financial risks within the financial institution's existing risk management framework.
- This includes the development of processes to measure and monitor material climate-related financial risks and communicate and report the materiality of those risks to internal stakeholders.

DATA, RISK MANAGEMENT AND REPORTING

- According to the Principles, sound climate-related financial risk management depends on the availability of timely, accurate, consistent, complete, and relevant data. Accordingly, the Principles expect that management will incorporate climate-related financial risk information into internal reporting, monitoring, and escalation processes to facilitate timely and sound decision-making across the financial institution.
- The Principles suggest that because available data, risk measurement tools, modeling methodologies, and reporting practices continue to evolve, management should monitor developments and incorporate them into climate-related financial risk management as warranted.

SCENARIO ANALYSIS

- Climate-related scenario analyses are used to conduct a forward-looking assessment of the potential impact on a financial institution of changes in the economy, changes in the financial system, or the distribution of physical hazards resulting from climate-related financial risks.
- Management should develop and implement a climate-related scenario analysis framework in a manner commensurate to the financial institution's size, complexity, business activity, and risk profile.
- The results should be clearly and regularly communicated to the board and all relevant individuals within the financial institution, including an appropriate level of information necessary to effectively convey the assumptions, limitations, and uncertainty of results.

MANAGEMENT OF RISK AREAS

- Management should consider and incorporate climate-related financial risks when identifying and mitigating all types of risk, such as credit, liquidity, operational, legal, and compliance risks.
- Regarding credit risk, the Principles state that management should consider climate-related financial risks as part of the underwriting and ongoing monitoring of portfolios, as well as in determining the institution's credit risk appetite.
- With respect to liquidity risk, the Principles provide that management should assess whether climate-related financial risks could affect the institution's liquidity position and, if so, incorporate those risks into their liquidity management practices and liquidity buffers.

CHANGES FROM THE PROPOSED PRINCIPLES

The final Principles contain several specific changes aimed at the feedback the FBAs received in comments to the draft Principles, including:

- Explicit statement that the Principles do not prohibit or discourage financial institutions from providing banking services to customers of any specific class or type, as permitted by law or regulation. The Principles state, "the decision regarding whether to make a loan or to open, close, or maintain an account rests with the financial institution, so long as the financial institution complies with applicable laws and regulations."
- Clarification that the Principles apply to foreign banking organizations with combined U.S. operations of greater than US$100 billion, as well as any branch or agency of a foreign banking organization that

individually has total assets of greater than US$100 billion.

- Clarification that the FBAs expect financial institutions to manage climate-related financial risks in a manner that will allow them to continue to prudently meet the financial services needs of their communities, including LMI and other underserved consumers and communities, and to ensure compliance with fair housing and fair lending laws.
- The Federal Reserve's proposed Principles suggested that boards consider whether climate-related financial risks may warrant changes to compensation policies. The final Principles remove this specific suggestion, yet the FBAs emphasize that "sound compensation programs [should] continue to be important to promote sound risk management and to protect the safety and soundness of financial institutions," citing existing guidance on compensation.

FEDERAL RESERVE GOVERNOR BOWMAN'S CRITICISMS OF THE FINAL PRINCIPLES

Federal Reserve Governor Michelle Bowman issued a dissenting statement to the Board of Governor's approval of the final Principles, stating that they "will create confusion about supervisory expectations and will result in increased compliance cost and burden without commensurate improvement to the safety and soundness of financial institutions or to the financial stability of the United States."[2]

Governor Bowman maintains that financial institutions of all sizes have long been expected to manage risks associated with their activities, including climate-related financial risks, and yet the Principles do not explain why unique treatment of climate risks is warranted. She indicates that the Principles could distract attention and resources from the core risks of credit risk, interest rate risk, and liquidity risk.

Governor Bowman also asserts that potential costs on banks could discourage banks from lending and providing financial services to certain industries and communities, forcing them to seek credit outside of the banking system from non-banking lenders and resulting in decreasing or eliminating access to financial services and increasing the cost of credit to these industries and communities.

Governor Bowman further worries that examiners will feel pressure to apply the Principles to smaller financial institutions.

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[2] https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20231024b.htm.

CONCLUSION

- While the Principles provide only guidance on the management of climate-related financial risks, the FBAs will expect financial institutions with over US$100 billion in consolidated assets to consider the Principles as they develop a program to manage climate-related financial risks. Large financial institutions should keep these expectations in mind as they also gear up for the increased capital and resolution planning requirements issued by the FBAs.
- While the Principles are intended for financial institutions with over US$100 billion in consolidated assets, financial institutions of all sizes should be familiar with them and consider making a risk-based determination on whether to implement some or all of the guidance, where appropriate and reasonable. Regardless of size, if a financial institution determines that climate risk, whether physical risk or transition risk, may be material to the institution, then adding climate risk to the institution's overall risk assessment and risk appetite would be warranted.
- Governance is key. At this early stage, the FBAs are likely to be primarily focused on whether the institution's governance framework facilitates effective climate-related risk assessments, management, and reporting to the board, rather than scrutinizing specific climate-related risk analyses and decisions. Financial institutions should consider assigning to one or more board committees the responsibility of defining the institution's climate risk appetite and assessing climate-related risk, opportunities, strategies, and risk mitigation plans, as well as ensuring that the board committees are receiving adequate information to perform these missions.
- The FBAs, like the U.S. Securities and Exchange Commission (SEC), are focused on potential misleading statements about institutions' climate-related statements. In response to public comments, the FBAs note that "when financial institutions engage in public communications of their climate-related strategies, boards of directors and management should confirm that any public statements about their financial institutions' climate-related strategies and commitments are consistent with their internal strategies, risk appetite statements, and risk management frameworks." This is the same message the SEC has reinforced through several enforcement actions against financial institutions accused of "greenwashing." Also, the SEC's proposed regulations on climate risk disclosure, expected to be finalized soon, would apply to SEC registered community banks as well as large financial institutions.

All financial institutions should ensure that material climate-related statements are adequately verified before publication, as government agencies – and plaintiffs' lawyers – are scrutinizing these statements closely.

Federal Deposit Insurance Corporation Proposes Large Bank-Like Corporate Governance and Risk Management Standards for FDIC-Supervised Depository Institutions With US$10 Billion or More in Assets

By Richard M. Alexander, Robert C. Azarow, James P. Bergin, David F. Freeman, Jr., Amber A. Hay, Michael A. Mancusi, Kevin M. Toomey, Anthony Raglani, Erik Walsh and Paul Lim*

In this article, the authors review a rule and guidelines proposed recently by the Federal Deposit Insurance Corporation relating to corporate governance and risk management standards.

The Federal Deposit Insurance Corporation (FDIC) has issued[1] a proposed rule and guidelines (NPR) that would require all FDIC-supervised insured depository institutions to adopt corporate governance and risk management standards that are comparable to those expected of banking organizations with US$100 billion or more in total consolidated assets (proposed guidelines).

In the NPR, the FDIC notes that the proposed guidelines "are drawn from the principles" in the risk management and corporate guidance issued by the OCC and the Federal Reserve Board for banking organizations with US$50 billion or more in total consolidated assets and US$100 billion or more in total consolidated assets, respectively.

However, the FDIC believes that its proposal to apply such principles more broadly to FDIC-supervised depository institutions with total assets of US$10 billion or more "is appropriate, as effective risk management practices should be tailored to the size of the institution and the nature, scope, and risk of its activities." With this proposal, the FDIC is lowering the threshold for the applicability of heightened corporate governance and risk management standards for FDIC-supervised institutions to US$10 billion or more.

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* The authors, attorneys with Arnold & Porter Kaye Scholer LLP, may be contacted at richard.alexander@arnoldporter.com, robert.azarow@arnoldporter.com, james.bergin@arnoldporter.com, david.freeman@arnoldporter.com, amber.hay@arnoldporter.com, michael.mancusi@arnoldporter.com, kevin.toomey@arnoldporter.com, anthony.raglani@arnoldporter.com, erik.walsh@arnoldporter.com and paul.lim@arnoldporter.com, respectively.

[1] https://www.federalregister.gov/documents/2023/10/11/2023-22421/guidelines-establishing-standards-for-corporate-governance-and-risk-management-for-covered.

As highlighted below, in some instances, the standards are more prescriptive and detailed than the standards in the principles-based guidance for banking organizations with US$100 billion or more in total consolidated assets. The FDIC published the NPR against the backdrop of the three bank failures in spring 2023. In the statement[2] published concurrently with the NPR, FDIC Chair Gruenberg stated that the experience of the recent bank failures should focus the FDIC's attention on the need for meaningful action to improve the corporate governance and risk management processes of large insured depository institutions (IDIs). The NPR is a significant step in that direction.

WHAT INSTITUTIONS WOULD BE COVERED BY THE NPR?

The NPR, if adopted as proposed, would apply to all insured state non-member banks, state-licensed insured branches of foreign banks, and insured state savings associations (i.e., FDIC-supervised insured institutions) that are subject to the provisions of Section 39 of the Federal Deposit Insurance Act (FDI Act), with total consolidated assets of US$10 billion or more (Covered Institutions).

For Covered Institutions with total assets of more than US$10 billion but less than US$50 billion, the proposed guidelines' heightened corporate governance and risk management standards are being imposed for the first time. Covered Institutions with assets greater than US$50 billion had been subject to heightened risk management standards for a brief period until the passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act in 2018.

Even for Covered Institutions with total assets of US$100 billion or more, the proposed guidelines impose more prescriptive and detailed requirements than what is currently expected of such large institutions. The FDIC is reserving its authority to apply the proposed guidelines in whole or in part to an institution that has total consolidated assets of less than US$10 billion. Total consolidated assets are measured based on an institution's total assets reported on its Call Report for the two most recent consecutive quarters.

WHAT IS REQUIRED UNDER THE PROPOSED GUIDELINES?

The FDIC notes in the NPR that the proposed guidelines would "codify the FDIC's expectations for effective corporate governance and risk management practices of a Covered Institution's risk profile" which suggests that even if the proposed guidelines are not adopted, the FDIC will have these expectations for its supervised entities.

The proposed guidelines set and delineate requirements, expectations, and obligations of the Board of Directors (Board) (including composition, duties,

[2] https://www.fdic.gov/news/speeches/2023/spoct0323.html.

and committees), Board and management responsibility regarding risk management and audits, and expectations with respect to identifying and addressing violations of law or regulations.

In terms of Board composition, the FDIC would expect that in addition to any requirements set forth in a Covered Institution's organizational documents or state chartering authority for Board members, the proposed guidelines would "expand upon, but [not] replace, these requirements by providing Covered Institutions various considerations for ensuring an effective board composition."

Similar to the Federal Reserve Board's guidance for effective board governance,[3] the proposed guidelines include standards for independent directors and Board diversity.

CORPORATE GOVERNANCE

A. Obligations of the Board and Individual Directors

In the NPR, the FDIC references the general fiduciary duties and obligations of a Board and individual directors under state laws, common law, and other applicable law. The NPR also references additional duties related to managing the affairs of the Covered Institution in a safe and sound manner in compliance with applicable law and regulations and considering the interests of all its stakeholders, including shareholders, depositors, creditors, customers, regulators, and the public.

B. Duties of the Board

To carry out the Board's overall responsibility for risk management of the Covered Institution and holding executives and management accountable, the NPR requires the Board to:

- Set an appropriate tone to promote responsible and ethical behavior and hold directors, officers, and employees accountable for unethical behavior or violations of law, regulation, or policy. The Board would also be expected to adopt a Code of Ethics and a Compensation and Performance Management Program and provide active oversight of management.
- Approve and adopt a written strategic plan that would discuss the Covered Institution's goals and objectives over, at a minimum, a three-year period. In addition, the strategic plan would be expected to articulate an overall mission statement and strategic objectives, contain a comprehensive assessment of current and potential risk factors, and

[3] https://www.federalreserve.gov/supervisionreg/srletters/SR2103.htm.

explain how the Covered Institution will review, update, and approve its risk management program to account for changes in the Covered Institution's projected risk, risk profile, risk appetite, or operating environment.

- Approve core policies that govern the operations of the Covered Institution and review such policies at least annually. Examples of policies identified as required for review include those that address real estate lending, Anti Money Laundering/Countering the Financing of Terrorism (AML/CFT) compliance, consumer protection laws, anti-fraud, and the Community Reinvestment Act (CRA).
- Adopt a written code of ethics that address conflicts of interest, self-dealing, protection of assets, recordkeeping, compliance with laws and regulations, and reporting procedures and a whistleblower policy. The Board would be expected to review and update the code of ethics at least annually.
- Select and appoint qualified executive officers who are qualified to administer the Covered Institution's affairs, including a chief risk officer and chief audit officer. The Board would also be required to develop and implement a succession plan and adequate training and personnel activities to ensure the continuity of qualified management and competent staff.

In addition, the NPR requires the Board to provide ongoing training to directors and engage in self-assessments to evaluate its adherence to the standards of the proposed guidelines.

C. Committees of the Board

The Board would be required to implement an organizational structure to keep directors informed and provide an adequate framework to oversee the Covered Institution. At a minimum, the Board must establish an Audit Committee, Compensation Committee, Trust Committee (if the Covered Institution has fiduciary powers), and Risk Committee. The FDIC would also expect a Covered Institution to establish specialty committees based on the complexity, activities, and the risk profile of the institution. For example, a Covered Institution that has a technology focus could be expected to have a committee for technology, cybersecurity, and privacy.

RISK MANAGEMENT

The proposed guidelines would require Covered Institutions to have a comprehensive and independent risk management function and effective programs for internal controls, risk management, and audits.

A. Risk Management Program

Covered Institutions would be expected to establish a risk management program that identifies, measures, monitors, and manages risks through a framework appropriate for the current and forecasted risk environment and that meets the minimum standards of the proposed guidelines. The risk management program, at a minimum, should cover credit, concentration, interest rate, liquidity, price, model, operational (including conduct, information technology, cyber-security, AML/CFT compliance, and third-party management), strategic, and legal risk. The Board should review and update the risk management program at least annually.

B. Risk Profile and Risk Appetite Statement

On a quarterly basis, the Covered Institution should review and update a risk profile that identifies current risks as well as a comprehensive written statement that establishes risk appetite limits for the covered institution, both in the aggregate and for lines of business and material activities or products. The risk appetite statement should reflect the level of risk that the Board and management are willing to accept and include both qualitative components and quantitative limits. The Covered Institution should communicate its risk appetite statement and risk management program to management and all employees to ensure that their risk-taking decisions are aligned with the risk appetite statement.

C. Three Lines of Defense Model

The proposed guidelines would adopt the three lines of defense model for risk management. Three distinct units should have responsibility and be held accountable by the chief executive officer (CEO) and the Board for monitoring and reporting on the Covered Institution's compliance with the risk management program. The three units are the front line units, the independent risk management unit, and the internal audit.

- *Front Line Units* — Front line units should assess and manage all of the risks associated with their activities and ensure that these risks do not exceed the established limits. Each front line unit, among other things, should establish written policies that include Board-approved risk limits and adhere to all applicable policies, procedures, and processes.
- *Independent Risk Management Unit* — Under the direction of the credit risk officer (CRO), the independent risk management unit should oversee the Covered Institution's risk-taking activities. The independent risk management unit should take primary responsibility for designing a comprehensive written risk management program, identify and assess, on an ongoing basis, the Covered Institution's material risks, ensure

compliance with risk management policies, procedures, and processes and with laws or regulations, and communicate with the CEO and the Risk Committee.

- *Internal Audit* — The internal audit should ensure that the Covered Institution's risk management program complies with the guidelines and is appropriate for the size, complexity, and risk profile of the Covered Institution. Importantly, the internal audit should remain independent of the front line units and the independent risk management unit.

D. Self-Reporting of Risk Limit Breaches and Violations of Law or Regulations

Front line units and the independent risk management unit, consistent with their respective responsibilities, would be expected to:

- Identify breaches of the risk appetite statement, concentration risk limits, and front line unit risk limits; inform front line unit management, the CRO, the Risk Committee, the Audit Committee, the CEO, and the FDIC in writing of a breach of a risk limit or any noncompliance; and establish accountability for reporting and resolving such breaches.
- Identify known or suspected violations of law or regulations; document all such violations and notify the CEO, Audit Committee, and the Risk Committee; and ensure that known or suspected violations of law involving dishonesty, misrepresentation, or willful disregard for requirements are promptly reported as required by law or regulation.

The Board should review and update the processes related to risk limit breaches and violations of law or regulations at least annually.

ENFORCEABILITY

Under Section 39 of the FDI Act, the FDIC may issue safety and soundness standards by guideline or regulation. If an institution fails to meet a standard prescribed by regulation, the FDIC must require the institution to submit a plan specifying the steps that it will take to comply with the standard. For a violation of a standard prescribed by the proposed guidelines, the FDIC has the discretion to decide whether to require the submission of a plan.

Here, the FDIC decided to issue the standards as binding guidelines rather than as non-binding guidance or a regulation to provide the agency with (1) an enforcement framework to ensure compliance, and (2) supervisory flexibility to pursue the course of action that is most appropriate given the Covered Institution's specific circumstances, including self-corrective and remedial

responses. For example, if the proposed guidelines are adopted and a Covered Institution fails to submit or implement an acceptable plan under the guidance, the FDIC, by order, may require the institution to correct the deficiency and may take additional enforcement actions, including growth restrictions, increased capital requirements, and restrictions on interest rates paid on deposits.

As noted below, the FDIC will expect Covered Institutions to maintain written records of any self-identified violations of law or regulations and report any violations to the FDIC in a prompt manner as well as any plans for remediation. However, there is no mention of how self-reporting will fit within the enforcement framework in terms of whether self-reporting would allow for an institution to avoid or qualify for reduced penalties.

CONCLUSION

According to the FDIC, the proposed guidelines, if adopted as proposed, would require 57 FDIC-supervised banks to establish and implement extensive corporate governance and risk management frameworks, and add over 91,000 labor hours in the first year for the Covered Institutions and approximately 90,000 hours each additional year to comply with the recordkeeping, reporting, and disclosure requirements.

Among other things, the standards under the proposed guidelines requiring self-reporting of risk limit breaches and violations of law or regulations go beyond what's required under the existing regulations and are likely to impose a substantial compliance and monitoring burden on affected institutions. Notably, the standards prescribed under the NPR largely track the OCC's guidelines establishing heightened standards for banks with US$50 billion or more in total assets (OCC Guidelines). In some instances, the NPR goes into considerably more detail than the OCC Guidelines and imposes more extensive obligations. If the NPR is finalized at the US$10 billion threshold as proposed, FDIC-regulated banks, especially small, community banks, may face a disparate burden compared to banks that are not state non-member banks.

Consumer Financial Protection Bureau Proposes to Supervise Larger Participants in the Market for Digital Payment Applications

By Valerie Hletko, Eric Mogilnicki, Michael Nonaka and Andrew Smith*

In this article, the authors discuss the Consumer Financial Protection Bureau's proposed rulemaking relating to digital payment applications.

The Consumer Financial Protection Bureau (CFPB) has issued a notice of proposed rulemaking[1] that would extend the CFPB's authority under Section 1024 of the Dodd-Frank Act to supervise larger participants in certain designated markets for consumer financial products and services to nonbank providers of "general-use digital consumer payment applications" (the Proposed Rule). The CFPB previously has exercised this authority to designate for supervision larger participants in five markets for consumer products and services: consumer reporting, consumer debt collection, student loan servicing, international money transfers (remittances), and automobile financing.[2]

The CFPB press release announcing the Proposed Rule acknowledged the widespread use among consumers and commercial firms of digital applications for consumer retail payment transactions, including sending money to friends and family. The Proposed Rule is intended in part to foster a level playing field between banks and larger non-bank financial institutions that provide consumer payment services. The press release includes a reminder that the CFPB currently has regulatory and enforcement authority over both banks and non-bank financial institutions that provide payment services.

The Proposed Rule is intended to enable CFPB examiners to conduct examinations of larger non-bank participants' compliance with consumer financial services requirements, including the prohibition on unfair, deceptive, and abusive acts or practices, funds transfer requirements, and privacy requirements.

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* The authors, attorneys with Covington & Burling LLP, may be contacted at vhletko@cov.com, emogilnicki@cov.com, mnonaka@cov.com and asmith@cov.com, respectively.

[1] https://files.consumerfinance.gov/f/documents/cfpb_nprm-digital-payment-apps-lp-rule_2023-11.pdf.

[2] 12 C.F.R. Part 1090, Subpart B.

THE SCOPE OF COMPANIES POTENTIALLY SUBJECT TO CFPB SUPERVISION UNDER THE PROPOSED RULE IS COMPLEX AND INFORMED BY A NUMBER OF DEFINITIONS AND EXEMPTIONS

The Proposed Rule, like the other five CFPB larger participant rules, defines the relevant market for consumer products and services. This market definition circumscribes the types of companies that may be subject to CFPB supervision. The Proposed Rule's threshold for a larger participant determines the specific companies operating in the relevant market that will be subject to supervision.

The relevant market under the Proposed Rule consists of companies that "provide a general-use digital consumer payment application," which is defined to mean "providing a covered payment functionality through a digital application for consumers' general use in making consumer payment transaction(s)." The Proposed Rule also defines certain terms used in this market definition:

- The term "consumer payment transaction(s)" means "the transfer of funds by or on behalf of a consumer physically located in a State to another person primarily for personal, family, or household purposes." The term includes transfers of consumer funds and transfers made by extending consumer credit, except for the following four categories of transactions that are exempt from the definition:
  - International money transfers subject to the existing larger participant rule for such transfers;
  - A transfer of funds by a consumer that is linked to the consumer's receipt of a different form of funds, such as a transaction for foreign exchange, or that is excluded from the definition of "electronic fund transfer" in Section 1005.3(c)(4) of Regulation E, which implements the Electronic Fund Transfer Act; [3]
  - A payment transaction conducted by a person for the sale or lease of goods or services that a consumer selected from an online or physical store or marketplace operated prominently in the name of such person or its affiliated company; and
  - An extension of consumer credit that is made using a digital application provided by the person who is extending the credit or that person's affiliated company.

[3] The exclusion in Section 1005.3(c)(4) of Regulation E applies to transfers of funds the primary purpose of which is the purchase or sale of a security or commodity regulated by the Securities and Exchange Commission (SEC) or Commodities Futures Trading Commission (CFTC), purchased or sold through a person regulated by the SEC or CFTC, or held in book-entry form by a Federal Reserve Bank or federal agency.

- "Covered payment functionality" means a "funds transfer functionality," a "wallet functionality," or both.
- "Funds transfer functionality" means, in connection with a consumer payment transaction, (1) receiving funds for the purpose of transmitting them, or (2) accepting and transmitting payment instructions.
- "Wallet functionality" means a "product or service that stores account or payment credentials, including in encrypted or tokenized form, and transmits, routes, or otherwise processes such stored account or payment credentials to facilitate a consumer payment transaction."
- "Digital application" means "a software program a consumer may access through a personal computing device, including but not limited to a mobile phone, smart watch, tablet, laptop computer, desktop computer."
- "General use" refers to "the absence of significant limitations on the purpose of consumer payment transactions facilitated by the covered payment functionality provided through the digital consumer payment application." [4]
- Parsing these definitions and exemptions, a non-bank financial institution that provides peer-to-peer payment services in which funds from the sender's bank account are transferred to the bank account of the recipient would be included in the market definition. Likewise, a non-bank financial institution would be included in the definition if it hosts a digital wallet that holds various third-party payment credentials that the consumer can access and use for payments without presenting a physical payment card.

THE THRESHOLD FOR A LARGER PARTICIPANT IS 5,000,000 ANNUAL CONSUMER PAYMENT TRANSACTIONS

A company is a "larger participant" in the defined market if it provides annual covered consumer payment transaction volume of at least five million transactions and was not a "small business concern" during the preceding

[4] Under the Proposed Rule, a payment functionality provided through a digital consumer payment application for consumer payment transactions would not have general use under the definition if the application is solely used: (1) to purchase or lease a specific type of services, goods, or other property, such as transportation, lodging, food, an automobile, a dwelling or real property, or a consumer financial product or service; (2) to purchase certain types of prepaid accounts excluded from Regulation E's definition of "prepaid account," including health savings and similar accounts, transit accounts, closed-loop government-issued accounts for limited use at government facilities, or certain types of gift cards and gift certificates; (3) to pay a specific debt or type of debt including repayment of an extension of consumer credit; or (4) to split a charge for a specific type of goods or services (e.g., restaurant or other similar bill splitting).

calendar year under the Small Business Act. "Annual covered consumer payment transaction volume" means "the sum of the number of consumer payment transactions that the nonbank covered person and its affiliated companies facilitated in the preceding calendar year by providing general-use digital consumer payment applications."

The Proposed Rule estimates that approximately 17 entities will be larger participants in the market and subject to CFPB supervision if the proposal is finalized.

THE PROPOSED RULE IS A CONTINUATION OF THE CFPB'S INTEREST IN REGULATING TECHNOLOGY COMPANIES THAT PROVIDE PAYMENT SERVICES

The Proposed Rule is the latest development in a series of CFPB orders and inquiries pertaining to technology companies' payments activities. In October 2021, the CFPB issued orders[5] collecting information from large technology companies that operate payments systems in the U.S. in order to better understand how these companies use payment data and manage data access. In August 2022, the CFPB warned[6] digital marketing firms that they must comply with federal consumer financial protection laws when using behavioral targeting techniques. In September 2023, the CFPB issued guidance[7] highlighting the impacts of technology companies' policies and practices that govern tap-to-pay on mobile devices such as smartphones and watches.

[5] https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-tech-giants-to-turn-over-information-on-their-payment-system-plans/.

[6] https://www.consumerfinance.gov/about-us/newsroom/cfpb-warns-that-digital-marketing-providers-must-comply-with-federal-consumer-finance-protections/.

[7] https://www.consumerfinance.gov/data-research/research-reports/big-techs-role-in-contactless-payments-analysis-of-mobile-device-operating-systems-and-tap-to-pay-practices/.

Avoiding Collateral Damage: Whose Pledged Assets Are They Anyway?

By Les Jacobowitz, Brooke Fodor, Megan (Woodward) Daily, Justin A. Kesselman, Alan S. Dubin, Matthew R. Bentley, and Malia K. Benison*

In this article, the authors discuss the practice of repledging.

The practice of repledging (sometimes referred to as "rehypothecation") is utilized in, among others, loan, swap, and brokerage transactions. In connection with troubled financing institutions, it may be a classic example of borrowing from Peter to pay Paul and was a focus during the 2008 financial crisis with the bankruptcy of Lehman Brothers. Following the recent collapses of FDIC-insured Silicon Valley Bank, Signature Bank, First Republic Bank, Heartland Tri-State Bank, and Credit Suisse, an in-depth analysis of this common practice deserves renewed attention.

REPLEDGING

In a typical secured transaction, a borrower pledges an asset (in most cases this involves securities, although it is possible that the pledged asset can be trade receivables or other collateral) to a lender as collateral to secure a loan.[1] The borrower retains ownership rights to the asset unless there is a default, in which event the lender is entitled to sell or retain the collateral.

What many borrowers fail to appreciate, however, is that despite the borrower's pre-default retention of ownership rights to the collateral, many standard loan documents permit the lender to further pledge the borrower's collateral, to secure the lender's own obligations to a third-party lender, and to facilitate the lender in making a new loan to a third-party borrower. This repledging could occur at any time, even prior to a default.

Moreover, if a lender repledges the borrower's collateral, and the lender thereafter becomes insolvent, then the borrower's only rights could be as an

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* The authors, attorneys with ArentFox Schiff LLP, may be contacted at les.jacobowitz@afslaw.com, brooke.fodor@afslaw.com, megan.daily@afslaw.com, justin.kesselman@afslaw.com, alan.dubin@afslaw.com, matthew.bentley@afslaw.com and malia.benison@afslaw.com, respectively. 2023 Summer Associates Denny Peixoto and Alexis Mozeleski assisted in the preparation of this article.

[1] Although these principles apply to real estate transactions, use of real estate as collateral is less likely to trigger repledging concerns. However, this caveat is inapplicable to receivables, securities and general intangibles, which are often pledged alongside real estate in the same transaction.

unsecured creditor vis-à-vis its own collateral in the lender's bankruptcy or receivership proceeding.

A WORD ABOUT NOMENCLATURE

This article refers to the borrower as "Borrower," the lender as "Original Lender," the bank swap counterparty as "Original Co-Lender" (who is most often the same as, or an affiliated entity of, Original Lender), and the third-party beneficiary of lender's repledge of the borrower's collateral as "Bank Lender."

REPLEDGING IMPACT

While the original example of repledging that we provided above was of a lender using property pledged as collateral by a borrower to secure the lender's obligations to a third-party, repledging can occur in a variety of different contexts (e.g., (1) a broker, as Original Lender, utilizing securities posted as collateral by the broker's client, as Borrower, (2) a swap provider, as Original Co-Lender, typically securing its obligations to a third-party with the same assets pledged to Original Lender).

Regardless of the types of parties involved, however, repledging is a practice that is completely legal, minimally regulated, and one to which Borrowers routinely consent through execution of standard documentation. However, this likely will only surface as an issue for a borrower when its lending institution is having liquidity issues as potentially occurred in Spring 2023 with certain troubled banks.

STANDARD DOCUMENTATION REGARDING REPLEDGING

Many standard documents (e.g., customer agreements with brokers, loan agreements with lenders, swap agreements with swap bank counterparties) permit repledging without restriction.

For example, the standard documentation for over-the-counter derivative transactions permits Original Co-Lender to repledge without Borrower's consent, and to repledge the pledged collateral before Borrower's default. The standard documentation also provides that if Borrower's pledged collateral is repledged, Original Co-Lender may retain the proceeds for its own use (as opposed to applying them to Borrower's obligations to Original Lender and Original Co-Lender). In addition, standard documentation sometimes permits (or does not prohibit) the repledge of Borrower's collateral in an amount greater than the amounts due to Original Lender.

WHY SHOULD BORROWERS CARE?

In a repledging scenario where Original Lender or Original Co-Lender becomes insolvent, Borrower would become an unsecured creditor, and may receive pennies on the dollar, on its own collateral, in any related bankruptcy proceeding of such lender.[2]

While being unaware of the potential pitfalls of repledging is, at least practically, of little consequence while financial institutions remain stable, the recent bank failures bring repledging into renewed focus.

LESSONS OF LEHMAN

In light of the banking failures of Silicon Valley Bank, Signature Bank and First Republic (as well as Credit Suisse), the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) proposed guidance and rules for larger banks to:

- Develop "living wills" to ensure their orderly liquidation;
- Issue unsecured long-term debt to, among other things, cushion any bank liquidity runs; and
- Enhance bank capital requirements.

This article now discusses the consequences and strategies for Borrowers when Original Lender or Original Co-Lender repledges their collateral and subsequently enters bankruptcy or other insolvency proceedings.

TYPES OF LENDER INSOLVENCIES

When Original Lender or Original Co-Lender becomes insolvent and collapses, it generally will commence a formal process to liquidate its assets for the benefit of creditors. Lenders other than banks may file for bankruptcy under Chapter 7 or Chapter 11 of Title 11 of the U.S. Code (the Bankruptcy Code). Insolvent banks are not eligible for bankruptcy and instead are placed in receivership and liquidated by the FDIC.

Under either regime, it is critical for parties doing business with the failed Original Lender or Original Co-Lender to understand the nature of their exposure and the process for protecting their interests.

SECURED VERSUS UNSECURED CLAIMS

The Bankruptcy Code creates a comprehensive priority scheme for the distribution of a debtor's property to creditors on account of their claims. Claims secured by a debtor's property are entitled to be paid in full up to the value of that property.

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[2] A similar analysis would be applied to the bankruptcy of not just Original Lender, but also any subsequent Bank Lender.

In contrast, unsecured creditors receive payments after the satisfaction of all secured creditors, based upon proportionate shares of the unencumbered assets less the amount of the costs of administering the bankruptcy. This often results in the unsecured creditors receiving only relatively small recoveries.

Similarly, in an FDIC receivership, secured creditors are entitled to be paid from their collateral; then administrative expenses of the receivership are paid; then uninsured bank deposits are paid; and finally, general unsecured claims are paid.

LIQUIDATING ORIGINAL LENDER OR ORIGINAL CO-LENDER COLLATERAL

The process for liquidating Original Lender's or Original Co-Lender's assets, which would include collateral pledged to them, typically moves quickly and has significant consequences for creditors with a claim to, or interest in, the property. Debtors frequently commence Chapter 11 bankruptcy cases with a proposal to sell their assets free and clear of any liens, claims, or interests pursuant to Section 363 of the Bankruptcy Code. These transactions are attractive to acquirers of distressed assets because the process moves quickly (21 days' notice unless shortened by the bankruptcy court) and cannot be unwound so long as the bankruptcy court finds that the acquirer acted in good faith.

A free-and-clear sale can have dramatic implications for other parties claiming an interest in the property. As discussed above, in a transaction in which Original Lender has not repledged collateral pledged to it by Borrower, unless Borrower defaults and loses its collateral by foreclosure, Borrower has the right to the return of its collateral once it has paid the obligation secured by the collateral.

However, once Original Lender repledges Borrower's collateral to Bank Lender, if Original Lender cannot pay its obligation secured by the repledged collateral, Original Lender will generally be unable to reclaim the repledged collateral from Bank Lender.[3] At that point, Borrower will only have a contractual right to reclaim its collateral from Original Lender and will not have

[3] This analysis applies in particular to collateral that is marketable securities, including securities that are in securities accounts over which Original Lender has "control" (a Uniform Commercial Code concept).

For example, brokers with discretionary investment authority have control over the clients' securities. Borrowers that pledge marketable securities to Original Lenders often do so in a manner that grants control to the Original Lenders. The Bank Lenders to which the Original Lenders repledge the Borrowers' collateral do not know, and have no diligence obligation to determine, whether the repledged collateral is actually owned by, or only controlled by, the Original Lenders. Since the Original Lenders have control, the Bank Lenders are generally

the right to demand the return of its collateral from Bank Lender. If, at that time, Original Lender is in bankruptcy or receivership, Borrower's contractual claim against Original Lender for the return of its collateral will most likely be converted into a general unsecured claim against Original Lender, leaving Borrower exposed to substantial potential losses.

The bankruptcy cases of Lehman Brothers shine a harsh light on these risks, while also providing a roadmap for future Borrowers facing similar circumstances.

THE LEHMAN TRILOGY

On September 15, 2008, Lehman Brothers, Inc. (Lehman Operating Co.) and certain affiliates commenced the largest bankruptcy case in United States history (and exacerbated the Great Recession), reporting assets and liabilities in excess of $600 billion. Four days later, the bankruptcy court entered an order approving the sale of most of Lehman Operating Co.'s assets (the Sale Order), including approximately $63 million in pledged securities (the Swap Collateral), to Barclays. After the sale, FirstBank Puerto Rico (FirstBank) filed a lawsuit against Barclays for damages and the return of Swap Collateral that it alleged Lehman Operating Co. had no right to sell.

Earlier Repledging

In 1997, FirstBank pledged the Swap Collateral to secure its obligations under an interest rate swap agreement (Swap Agreement) with Lehman Brothers Special Financing, Inc. (Lehman Swap Provider). The obligations of Lehman Swap Provider under the Swap Agreement were guaranteed by Lehman Brothers Holdings, Inc. (Lehman Parent). The Swap Agreement provided that, if Lehman Swap Provider defaulted under the Swap Agreement, it was contractually obligated to return the Swap Collateral to FirstBank. It also afforded Lehman Swap Provider the right to repledge the Swap Collateral, which meant that, if Lehman Swap Provider did default under the Swap Agreement after having repledged the Swap Collateral, it would be obligated to reacquire the Swap Collateral, or substitute comparable collateral, in order to return it to FirstBank.

This pattern occurs in the ordinary course of a swap provider's business, when the collateral pledged to it consists of marketable securities but can be disrupted by bankruptcy or other similar proceedings.

Bankruptcy Filings

Lehman Swap Provider repledged the Swap Collateral to Lehman Operating Co. under a repurchase agreement that granted Lehman Swap Provider the

entitled to assume that the Original Lenders have the power to transfer complete ownership of the repledged marketable securities.

right to repurchase the Swap Collateral from Lehman Operating Co. However, when Lehman Swap Provider defaulted under the Swap Agreement with FirstBank, it did not repurchase the Swap Collateral from Lehman Operating Co.

Shortly after Lehman Swap Provider defaulted under the Swap Agreement, Lehman Operating Co. and Lehman Parent filed for bankruptcy. The bankruptcy court approved, on an expedited basis, Lehman Operating Co.'s free-and-clear sale of the Swap Collateral to Barclays. The bankruptcy court acted so quickly because of the worldwide implications of Lehman Brothers' bankruptcy. Notice of the sale was not provided to FirstBank. FirstBank sent a notice of default to Lehman Swap Provider but did not demand the return of the Swap Collateral until after the Sale Order had been approved and the Swap Collateral had been sold to Barclays – neither of which FirstBank was aware of. Lehman Swap Provider then filed for bankruptcy.

Court Rulings

In a series of decisions, the bankruptcy court ruled that FirstBank was not entitled to an order requiring Barclays to return the Swap Collateral, even though, as against Lehman Swap Provider, FirstBank was entitled to the return of the Swap Collateral.[4] By having agreed to the repledging provision in the Swap Agreement, FirstBank had also agreed that, once Lehman Swap Provider repledged the Swap Collateral to Lehman Operating Co., FirstBank lost its property interest.

As a result, FirstBank could not sue Barclays for the return of the Swap Collateral or damages because (i) FirstBank had no remaining interest in the Swap Collateral and no contractual relationship with Barclays, and (ii) Barclays was a good faith purchaser with no diligence obligations and was otherwise barred by the Sale Order, even though FirstBank did not receive notice of the sale since the Swap Collateral had already been repledged by Lehman Swap Provider to Lehman Operating Co. (and likely was not required under the underlying documents to receive notice of the original repledge to Lehman Operating Co.).

Under the bankruptcy court's orders, FirstBank had valid breach of contract claims against Lehman Swap Provider because of its failure to (i) fulfill its payment obligations under the Swap Agreement, and (ii) reacquire and return the Swap Collateral to FirstBank. These breach of contract claims amounted to

[4] See In re Lehman Bros. Holdings Inc., 492 B.R. 191 (S.D.N.Y. Bankr. 2013); In re Lehman Bros. Holdings Inc., 526 B.R. 481 (Bankr. S.D.N.Y. 2014); In re Lehman Bros. Inc. (S.D.N.Y. Bankr. Nov. 23, 2015).

approximately $61 million, based on the value of the Swap Collateral in excess of FirstBank's remaining obligations under the Swap Agreement. But these were determined to be general unsecured claims against the bankruptcy estates of Lehman Swap Provider and Lehman Parent (as guarantor under the Swap Agreement).

Unfortunately for FirstBank, it did not file proofs of claim in the bankruptcy proceedings against either Lehman Swap Provider or Lehman Parent. Instead, FirstBank filed a proof of claim in Lehman Operating Co.'s liquidation proceeding under the Securities Investor Protection Act (SIPA) as a customer entitled to return of deposited funds. The bankruptcy court held – correctly – that a "customer" under the SIPA does not include a swap counterparty, basing its decision on the principle that a customer is an investor that entrusted its marketable securities to a broker-dealer to make investments on the customer's behalf. Consequently, FirstBank was not entitled to any SIPA recovery.

RISK MITIGATION IN LIQUIDATION OF ORIGINAL LENDER OR ORIGINAL CO-LENDER

Although Lehman Brothers was an anomaly in terms of size, scope, and speed, the risks inherent in repledging remain ever present and require swift action when Borrowers are faced with a troubled Original Lender or Original Co-Lender in bankruptcy or an FDIC receivership. Borrowers with rehypothecation provisions in their financing agreements can protect themselves by following the principles discussed below during insolvency proceedings.

Stay Informed

Upon any signs of banking or lender failure, Borrowers should determine:

- Who are the right debtors (lender and guarantor)?
- What is happening in the bankruptcy case of the debtor and its affiliates?
- Where is the collateral?
- Is there a proposed sale of collateral?
- How will the collateral be affected?

Move Quickly

Bankruptcy or receivership sales can happen within a month of filing. Importantly, upon the onset of significant liquidity concerns, Original Lender and Original Co-Lender have every incentive to conduct 'fire sales' of their assets, as well as all Borrower collateral pledged to them.

Although the sale in Lehman Brothers occurred more quickly than the typical case, the trend in Chapter 11 has been for Section 363 sales to occur

early in the case and on an expedited timeline. It is imperative for interested parties to become involved at the outset and to object to relief that may prejudice their rights and interests – even if they have not received all of the notice and information to which they might technically be entitled.

Borrowers should remember that, since FirstBank was not a creditor of Lehman Operating Co., the bankruptcy court determined that FirstBank was not entitled to notice that Lehman Operating Co. was selling the Swap Collateral free and clear to Barclays. Although it is not certain that FirstBank would have been able to block the sale in that case, there may be circumstances where a Borrower would be able to improve its position by timely seeking relief from the bankruptcy court – for example, if there has been fraudulent or unfair conduct by a pledge recipient such as, potentially, Lehman Operating Co. Indeed, the bankruptcy court permitted Lehman Parent to pursue misconduct claims against its operating bank and swap counterparty in another litigation arising from the Lehman Brothers bankruptcy.

Once a sale of repledged collateral is approved, however, it becomes extremely difficult (if not impossible) to unwind.

File Claims Timely (Against the Correct Parties)

Sometimes it is unclear whom is the proper party to pursue, particularly in the face of a web of debtors with a byzantine and complex corporate structure.

Repledging makes matters more difficult by clouding the location and ownership of Borrower's collateral – an issue FirstBank faced for several months in trying to track down the Swap Collateral. Borrowers should not wait idly for information, which troubled Original Lenders or Original Co-Lenders may be hesitant to provide, or delay providing, since providing clear information to Borrowers might enable them to file an appropriate and timely claim, thereby jeopardizing a Section 363 sale of the Borrower's collateral to meet dire liquidity needs of a failing financial institution. As mentioned above, after a bankruptcy court sale, the collateral will likely belong to the Bank Lender rather than the Borrower.

Instead, Borrowers should take a multi-pronged approach that includes, at a minimum:

(i) Sending default notices before a bankruptcy filing;

(ii) Filing proofs of claim against any contractual counterparties listed in the financing documents; and

(iii) As discussed above, closely monitoring the proceedings of those counterparties *and their affiliates* for material developments that could prejudice their interests.

Had FirstBank filed proofs of claim against both Lehman Swap Provider and Lehman Parent for the $61 million in excess Swap Collateral, it likely would have received approximately $41.5 million based on public disclosures regarding the dividends issued to general unsecured creditors of Lehman Swap Provider and Lehman Parent.[5]

CONCLUSION

In summary, let's just hope that *The Lehman Trilogy* does not become a recurring series in connection with future banking failures.

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[5] See In re Lehman Brothers Holdings Inc., 08-bk-13555, Final Decree, Dkt. No. 61141 (indicating 40.40% recovery on general unsecured claims against Lehman Swap Provider); see also Notice Regarding Twenty-Sixth Distribution, Dkt. No. 61564 (indicating 27.55% recovery on third party guarantee claims against Lehman Parent); see also Modified Third Amended Joint Chapter 11 Plan, Dkt. No. 22973, pp. 77-78 (claimants entitled to distributions from separate debtors on account of separate proofs of claim until the claim is paid in full).