C A D W A L A D E R

Cabinet **News and Views**

Informed analysis for the financial services industry

Springing Forward

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In This Issue ...

Welcome back to *Cabinet News and Views*. As the first month of 2024 is well underway, it is proving to be a busy start as global regulators look to tackle major challenges.

In this issue, we touch on a variety of topics including the latest developments from the financial services regulatory agencies, the UK's banking regulator priorities in 2024, the impact of the Retained EU Law and more.

As always, your comments and questions are valued. Feel free to reach out to us anytime by dropping a note here.

Mercedes Tunstall and Alix Prentice
Partners and Co-Editors, *Cabinet News and Views*

CFPB Finalizes Rule to Limit Credit Card Late Fees to $8

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

On March 5th the Consumer Financial Protection Bureau ("CFPB") announced that it had finalized its rule revisions to Regulation Z and the Official Staff Commentary regarding "Credit Card Penalty Fees." See a redline of the resulting changes to Regulation Z, here. Alleging the Federal Reserve's implementation of the CARD Act in 2010 led to a loophole "that allowed credit card companies to sidestep accountability if they charged" late fees consistent with the dollar amounts chosen by the Federal Reserve (i.e., $25 for the first late payment, and $35 for subsequent late payments, adjusted for inflation, which is $32 and $43 today), the CFPB declared that the maximum late fee that can be charged for a late credit card payment is $8, regardless of inflation and regardless of the number of times a payment has been made late. (Card issuers that have less than one million open accounts can still charge the inflation-adjusted late fees set by the Federal Reserve in 2010.)

Card issuers with more than one million open accounts may charge more than $8 for late fees, but only if they "show their math." This means that if they can prove the higher fee is necessary to cover their actual collection costs, then they can charge a higher late fee. Notably, however, the Official Staff Commentary has been updated to specify that "collection costs that are incurred after an account is charged off in accordance with loan-loss provisions" may not be included in the "actual collection costs" of a card issuer for purposes of establishing the late fees. Despite widespread comments from industry and trade groups regarding how substantial post-charge-off costs are, the CFPB replied that "the costs in collecting amounts owed to a card issuer that are incurred post-charge-off are substantially related to mitigating a loss" and are not related "to the cost of a violation of the account terms" and therefore, the post-charge-off costs are not collection costs. And, further, the CFPB pointed out that if such post-charge-off costs were allowed to be included in the late fee calculation, "the majority of consumers who pay late fees—whose accounts were merely delinquent and not written off—would be compensating issuers for losses that have nothing to do with their own late payment violations, but rather result from the small minority of delinquent accounts that might be written off."

That logic – it is bad to make a group of card customers worse-off as a result of behavior that is not their own – is not consistently applied by the CFPB, of course. For the majority of credit card customers who never pay late, the impact that reducing late fees to $8 is likely to have will result in higher interest rates and lower credit lines. Importantly, in its zeal to provide "an average savings of $220 per year" for the credit card customers who habitually pay late fees, the CFPB may not only be disrupting the credit card industry, but may also be severely impacting the access to credit by such credit card customers.

Vice Chair Barr Delivers Remarks on Fed's Counterparty Credit Risk Supervisory Priorities

By **Lary Stromfeld**
Partner | Financial Regulation

By **Nikita B. Cotton**
Associate | Financial Regulation

Last week, we attended the invitation-only conference on counterparty credit risk ("CCR") cohosted by the Basel Committee on Banking Supervision and the Federal Reserve Bank of New York. Michael S. Barr, the Fed Vice Chair for Supervision, delivered opening remarks regarding how the financial system has become ever more complex due to an "increasingly varied and evolving collection of nonbank clients," requiring banks to develop new approaches to CCR management.[1]

By way of background, CCR is the risk that a transaction counterparty defaults before final settlement. Under current U.S. capital rules, large banks are required to identify transactions that expose them to CCR and maintain corresponding regulatory margin for derivatives, long settlement transactions and securities financing transactions. CCR is one of many components of the capital rules that are set to change (and require banks to maintain more margin than they do today) when the prudential regulators implement their final Basel III Endgame rules.

Mr. Barr stated that the Fed will focus on the following risk management practices in their ongoing supervision of banks:

(1) *Thorough due diligence at onboarding*. Banks should seek information and disclosures from their counterparties in order to enable them to understand counterparties' risk profiles, and take it into account if counterparties will not provide such disclosures. Vulnerabilities such as excessive concentrations and leverage could lead to major losses.

(2) *Measuring risk and the importance of margining through a counterparty relationship*. In order to appropriately measure counterparties' risk profiles, banks should have at their disposal a range of risk measurement tools that can aggregate risk across and within products, business lines and clients, and capabilities to understand and assess such tools in order to maintain appropriate margin.

(3) *Setting and responding to prudent risk limits*. Banks should establish limits on the amount of risk they are willing to accept, and internal escalation and remediation processes when limits are reached. Further, banks should be proactive, have multiple measures of CCR and maintain adequate staffing, strong documentation and clear roles and responsibilities to facilitate accountability.

The Fed also uses its own tools for assessing CCR, and plans to publish the results of several exploratory analyses alongside this year's stress test results, which include an analysis of the resilience of the G-SIBs to the simultaneous default of their five largest hedge fund counterparties.

Mr. Barr shared that the conference was, in part, a byproduct of the default by Archegos Capital Management that rippled through the global financial system in March 2021 and exposed weaknesses in banks' CCR management practices. Mr. Barr also highlighted the liquidation of leveraged Treasury positions by hedge funds in 2020, losses in the liability-driven investments of pension funds in the United Kingdom in 2022 and recent volatility in global commodities markets as events that demonstrate the importance of margining practices for all asset classes —even those that are highly liquid or traditionally thought of as safe exposures.

Some other significant takeaways from Mr. Barr's remarks are that internal risk managers should have real influence on banks' risk decisions such that risks are not ignored; margining practicing should be "conservative"; and "weakening standards on margin or terms and conditions should not be a negotiation point to win business."

Lastly, we note that Lary Stromfeld was a panelist on "Legal Perspectives" at the conference. If you have any questions about CCR or how it could affect your bank's regulatory capital requirements, please don't hesitate to reach out to Lary and the other members of Cadwalader's Basel III Endgame Taskforce.

[1] As the two-day conference was held under "Chatham House" rules, our summary is limited to those remarks of Mr. Barr's that were made public.

CFPB Declares Supervision Authority in a Contested Matter for the First Time

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

On February 23rd the Consumer Financial Protection Bureau ("CFPB") published its first supervisory designation order in a contested matter. While the decision was reached in November 2023, the announcement of the decision publicly is intended to "provide transparency about how it assesses risks using consumer complaints and other factors."

In April 2022, the CFPB "invoked" what it characterized as "dormant authority" in the Consumer Financial Protection Act to allow it to conduct examinations of and otherwise supervise "nonbank financial companies that pose risks to consumers." When the CFPB exercises this authority to declare the right to supervise a nonbank, the entity has the right to consent to supervision, or the entity may contest the supervision authority pursuant to CFPB procedural rules. Pursuant to those rules, the entity may contest the notice of supervision, albeit through the echo chamber of the CFPB.

First, the process involves submitting to the applicable CFPB Associate Director written materials, and the option to provide oral testimony. The Associate Director then makes a determination and recommendation to the CFPB Director, who can then adopt, modify or supersede the Associate Director's recommendation and take a "final agency action" with respect to supervision of the entity.

In the contested matter announced, the CFPB did have the grace to say that, "importantly, the CFPB's order does not constitute a finding that the entity has engaged in wrongdoing." Nevertheless, in his decision, the CFPB Director, Rohit Chopra, pointed to four elements of the entity's conduct that lead to the decision to supervise the entity – a licensed lender that makes unsecured personal loans, which the CFPB reports sometimes have APRs as high as 100%.

The elements that led to supervision include concerns that: 1) customers do not understand that insurance coverage tied to the loans is optional; 2) the lender uses "excessive, harassing and coercive collection practices"; 3) the lender both does not engage in accurate credit reporting and does not respond adequately to consumer disputes of credit reporting; and 4) serial refinancing of loans made by the lender "may harm consumers in a variety of ways."

Based upon the concerns highlighted by the CFPB in this order, it is not unreasonable to wonder why the CFPB did not use enforcement powers such as a civil investigative demand ("CID") to obtain the information it needs to determine if violations of law have occurred, and why it is bothering to declare supervision first. Simply put, supervision grants the CFPB full access to the entity's documents, systems, employees and information, whereas a CID necessarily provides limited information to the CFPB. Should the CFPB, after having full access to the entity through supervision and determine that there are indeed problems, the CFPB can

address those problems by issuing a supervision exam report with a number of Matters Requiring Attention ("MRAs") and Matters Requiring Immediate Attention ("MRIAs") that should be resolved within prescribed time limits. But, the CFPB supervisory team may also choose to make a recommendation to the enforcement side to take enforcement action, based upon the materials gathered by the supervisory team. In that case, because the agency already has as many materials as it wants and the enforcement team can take immediate and decisive action, leaving little room for the entity to defend itself.

The European Parliament Adopts New Measures on Banks Requirements to Hold Loss Absorption and Recapitalisation Instruments in the Event of a Resolution Requirement

By **Alix Prentice**
Partner | Financial Regulation

The European Parliament has adopted a Directive amending the Bank Recovery and Resolution Directive (*2014/59/EU*) ("BRRD") and the Single Resolution Mechanism ("SRM") Regulation (*806/2014*) concerning the minimum requirement for own funds and eligible liabilities ("MREL").

The BRRD requires banks in the EU to meet a minimum requirement for MREL in order to ensure the effective application of the bail-in tool and appropriate loss absorption and recapitalisation when there is the need for bank resolution. An analysis of the existing rules revealed that applying the deduction requirement for an 'internal MREL' assessment could disproportionately and negatively affect certain banks when an MREL instrument is issued by a group subsidiary and directly or indirectly subscribed for by a parent company. This so-called 'internal MREL', when indirectly subscribed for, must currently be deducted from the own funds of the intermediate subsidiary in order to ensure the integrity and loss absorbency of the MREL instruments.

The new rules, which are known as 'Daisy Chains', allow local resolution authorities the power to set this internal MREL on a consolidated basis such that the intermediate subsidiaries involved will not be required to deduct their individual holdings of MREL. In addition, 'liquidation entities' within banking groups (which are demarcated for winding-up under local insolvency laws) would not be obliged to comply with MREL requirements unless the relevant resolution authority decides that this is necessary for financial stability purposes on a case-by-case basis.

The next steps involves the new Directive entering into force 20 days after its publication in the Official Journal of the European Union. Member states will then adopt and publish implementing measures for the proposed Directive six months from the date of its entry into force and to apply those measures from the following day.

The UK Regulator Writes to Asset Manager CEOs

By Alix Prentice
Partner | Financial Regulation

The UK's Financial Conduct Authority ("FCA") has issued a 'Dear CEO' letter to asset managers updating its approach over the coming year to areas of regulatory focus in the light of recent changes in the external risk environment following the market shocks of 2023, as well as the outcome of certain FCA review work.

Themes

Along with discussions on the promotion of innovation and projects involving international engagement, the letter focuses on:

1. *Assessments of Value and Consumer Duty*: The FCA continues to monitor how managers of authorised funds are performing the required Assessments of Value of the funds they offer, and is finding that customer outcomes remain variable. 2024 will see the FCA also building in the features of the Consumer Duty that require asset managers to consider price and value as well as services provided when dealing with retail customers.
2. *Change Management*: Topics covered here include requirements to build operational resilience that will see in-scope firms obligated to have mapped and tested impact tolerances for each important business service by 31 March 2025, and to have made any necessary changes and investments to ensure that they remain within those tolerance parameters. Firms' progress in embeddding the FCA's Guiding Principles for ESG and sustainable investment funds is also under the microscope, as is progress on implementation of the Sustainability Disclosure Requirements ("SDR") and investment labelling requirements much of which will be in force this year. SDR and the labelling regime include requirements for firms that promote their ESG credentials to structure their board and governance arrangements to oversee and review management information on ESG, third-party ESG information providers used and the claims their firms make about ESG, and the FCA will be looking to firms to make sure that these requirements are met and adequately resourced.
3. *Valuation Practices for Private Assets*: Building on its recent communications on liquidity management, and in the light of an ever-increasing proportion of fund assets held in private assets, the FCA is keen to stress that valuations in this less transparent asset class are robust and reliable, and will be conducting a review looking at valuation practices for private assets, again including board oversight and accountability.
4. *Market Integrity and Disruption*: Along with other international supervisory authorities, the FCA will continue to look at ways to improve money market funds' resilience, funds with significant liquidity mismatches and the transfer of risk from the non-bank financial sector to the rest of the financial markets. In particular, the FCA will be looking at large, concentrated and highly leveraged positions, and will want to see appropriate risk management processes in place to mitigate market impacts.

Next Steps

The FCA is clear that the letter is to be discussed at Board level, and if necessary, action taken. It is also clear that the FCA will continue to focus on the effectiveness of governance arrangements in making sure that there is senior management accountability for risk management, oversight and appropriate management information flow to enable good decision making.

Former FDIC Counsel Rejoins Cadwalader in New York

Cadwalader partner and bank regulation head Andrew Karp spoke with *Law360* about his joining the firm from the FDIC and the current environment facing the banking industry.

"Bank regulatory work is fascinating because it involves matters where policy, business imperatives, and law intersect," Andrew said. "And now, a recent wave of regulatory and supervisory developments, such as bank capital proposals and enhanced supervisory scrutiny, suggests that those matters will become even more interesting and important to banks, their investors, and their counterparties. I'd like to be part of a team that can help such clients successfully address those matters."

Read it here.