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Comments Detail Potential Impact from New Basel Capital Proposal

by David A. Luigs

On April 16, 2010, the comment period closed on two draft proposals issued in December 2009 by the Basel Committee on Banking Supervision (the "Basel Committee"): (1) the proposal for strengthening the resilience of the banking sector (the "Capital Proposal") and (2) the proposal for managing liquidity risks (the "Liquidity Proposal" and, together with the Capital Proposal, the "Basel Proposals"). The Basel Proposals are intended to address weaknesses in the Basel II framework revealed by the global financial crisis, and they were discussed in detail in the January 2010 issue of the *Debevoise & Plimpton Financial Institutions Report* available at www.debevoise.com.

The response to the Basel Proposals — including more than 250 public comment letters received by the Basel Committee — provides a detailed look at the potentially immense impact of the Basel Proposals on financial institutions and the broader economy. This article summarizes the potential impact of, and highlights principal concerns that have been raised with respect to, the Capital Proposal.

Timing

The full impact of the Capital Proposal will not be known until after it is finalized. A Quantitative Impact Study ("QIS") to measure the potential impact is now under way. The results of the QIS are expected by mid-year, and the Basel Committee intends to discuss the initial QIS results at its July meeting.

The process is intended to move quickly. The goal is to have a full set of revised standards, with specific "appropriately calibrated" numerical requirements, developed by the end of 2010. The new requirements would then be implemented by individual institutions by the end of 2012. Although the Basel Committee has emphasized that there may be transitional arrangements, many have raised concerns about the speed expected for implementation, and that there should be additional comment and QIS periods as the Basel Proposals become more concrete.

The Capital Proposal calls for (1) a new core capital requirement restricted to common equity and retained earnings, subject to regulatory adjustments, (2) restrictions on capital instruments that may be included in Tier 1 (limiting hybrid instruments), (3) the introduction of a new leverage ratio and counter-cyclical buffers, and (4) increased risk coverage for counterparty credit risk exposures arising from derivatives, repurchase agreements and securities financing activities. Separate from the Capital Proposal, the Basel Committee introduced two new global liquidity standards, short-term and long-term, in the Liquidity Proposal, which have also been the subject of detailed comments.

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Total Capital Impact

Although the Capital Proposal does not yet contain numerical specifications, *e.g.*, for the new common equity requirement or leverage ratio (which are to be calibrated following the QIS), commentators predict that the impact could be immense. Letters from two European bank federations estimated that institutions in Europe alone could face capital shortfalls in the neighborhood of $485 to $783 billion. Another study estimated that overall Tier 1 capital ratios could drop by approximately half, requiring the largest 32 banks to raise up to $650 billion in total equity, with the very largest banks needing an average of more than $20 billion each.

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U.S. Insurance Holding Company Act Litigation: Kingsway and the Pennsylvania Insurance Department

by John Dembeck

The U.S. insurance holding company statutes are designed, among other things, to require prior regulatory approval of an acquisition of control of a domestic insurer and regulatory review of certain transactions involving a domestic insurer. The scope of these kinds of provisions was the subject of litigation between Kingsway Financial Services, Inc., a Canadian publicly traded corporation ("Kingsway"), and the Pennsylvania Insurance Department ("PID") over the disposition of Kingsway's subsidiary, Lincoln General Insurance Company. This litigation is important since the claims of the PID are based on provisions of Pennsylvania's insurance holding company statute that are essentially the same as those of all other states.

In a decision of the Commonwealth Court of Pennsylvania dated April 1, 2010 (Case No. 611 M.D. 2009), the court dismissed the PID petition and held that Kingsway's actions did not violate the Pennsylvania insurance holding company statute. The PID has filed a notice of appeal to the Pennsylvania Supreme Court regarding this decision and has proposed amendments to the NAIC Insurance Holding Company System Regulatory Act to address the issue presented by the Kingsway litigation.

This article discusses the events that led to the dispute between Kingsway and the PID, what their respective positions were and why the court reached the decisions it reached.

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Kingsway and the Disposition of Walshire Common Stock

Prior to the transaction that gave rise to the dispute with the PID, Kingsway, through its wholly owned subsidiary, Kingsway America, Inc., owned Walshire Assurance Company ("Walshire"), which in turn owned Lincoln General Insurance Company ("Lincoln General"). Both Walshire and Lincoln General were Pennsylvania domestic property/casualty insurers.

According to the PID, (1) Kingsway acquired Lincoln General in 1998, (2) Lincoln General's net written premiums increased from $33 million in 1999 to as high as $1 billion in 2004, (3) Lincoln General's surplus diminished from $160 million in 2004 to $79 million in 2008 and to less than $7 million as of September 30, 2009, and (4) Lincoln General was placed into run-off in March 2009. On October 19, 2009, Kingsway disposed of its ownership interest in Lincoln General by having its messengers deliver to each of 20 charities in the New York City area a stock certificate representing 5% of the outstanding common shares of Walshire together with a donation of $20,000. Kingsway did this without prior notice to or approval of the PID. Kingsway purported to do this since there was a risk that Lincoln General would be put into receivership by the PID and a receivership proceeding would constitute a breach of a Kingsway debt covenant.

> **This litigation is important since the claims of the PID are based on provisions of Pennsylvania's insurance holding company statute that are essentially the same as those of all other states.**

The PID objected to the transaction, claiming that Kingsway had violated several provisions of Pennsylvania law, including two provisions of the Pennsylvania insurance holding company statute. Kingsway filed for a declaratory judgment that its actions were in compliance with relevant law. The PID in turn filed for a declaratory judgment and sought an injunction against the transaction, claiming it violated three different Pennsylvania laws.

The three violations claimed by the PID, Kingsway's response and the court's holdings are each set forth below.

No Form A Filing/Approval

The Pennsylvania insurance holding company statute requires that a person submit a Form A filing and obtain the approval of the PID when a transaction would cause a person "to acquire control of a domestic insurer." Pennsylvania law defines "control" to mean "the power to direct or cause the direction of the management and policies" of a person. Owning or controlling 10% or more of the voting securities of a person gives rise to a rebuttable presumption of control.

The PID claimed that, since the disposition constituted 100% of the voting shares of Lincoln General, the PID should have been given the opportunity to review the transaction. While the PID cites Pennsylvania law that defines a "person" as a collection of persons acting in concert and states that,"[i]f Kingsway had been successful in turning the charities into collective acquiring parties," a Form A filing and regulatory approval would have been required, the PID never actually claims that the charities were acting in concert. The real concern of the PID was probably best expressed by the PID as follows: "to accept Kingsway's interpretation of the Act would open the floodgates for any insurance holding company to rid itself of a financially-troubled subsidiary in the same manner that Kingsway attempted to rid itself of Lincoln General without regard to the insurer or its policyholders."

Kingsway responded that, as a result of the transaction, no person acquired control of Lincoln General. No one charity acquired more than 5% of the voting shares of Lincoln General. Furthermore, no exemption from the Form A filing and approval requirements was required since no charity was presumed to have acquired control of Lincoln General – each acquired 5% of Walshire's voting shares, an amount below the 10% of voting shares presumed control threshold. Lastly, Kingsway stated that the PID did not allege, and could not allege, that the charities acted in concert.

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The court agreed with Kingsway. The Pennsylvania insurance holding company statute (like most state holding company statutes) also provides that the PID "may determine, after furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support such determination, that control exists in fact, notwithstanding the absence of a presumption to that effect." The court also observed that the PID did not allege that it had determined after notice and an opportunity to be heard, and the making of specific findings of fact, that the charities had control of Lincoln General by virtue of their holding 5% of the Walshire stock.

No Affiliate Transaction Filing

The Pennsylvania insurance holding company statute requires prior filing with the PID on a Form D of certain affiliate transactions – the statute describes these as transactions "involving a domestic insurer and any person within its holding company system." One such transaction is a sale of assets in an amount that exceeds a certain materiality threshold.

The PID claimed that the disposition of the interest in Lincoln General by Kingsway (1) was a transaction involving a domestic insurer, Lincoln General, and its parent, Kingsway, (2) involved a sale of assets, namely, all the assets of Lincoln General, and (3) was a transaction that exceeded the applicable materiality threshold.

Kingsway responded that the Pennsylvania law requiring a Form D filing was not applicable since Lincoln General was not a party to the disposition transaction – only Kingsway and the charities were parties to the disposition transaction.

The court agreed with Kingsway and held that the transaction involved 20 charities that are not in the Lincoln General holding company system.

In its holding, the court gave no express deference to the PID's views and focused solely on the statutory wording....

G4A Plan of Asset Transfer

An uncodified provision of Pennsylvania law, 15 P.S. 21205(a), dubbed "G4A," requires PID prior approval for a "plan of . . . transfer" of an "insurance corporation." Lincoln General is an "insurance corporation" within the meaning of the law.

The PID claims that the disposition represented an asset transfer of an insurance corporation – Lincoln General – in that 100% of Lincoln General's assets were transferred to the 20 charities.

Kingsway responded that whatever corporate assets Lincoln General had before the disposition transaction remained the corporate assets of Lincoln General after the disposition transaction. Kingsway further argued that a transfer of a corporation's stock is neither a transfer of that corporation's assets nor a transfer of the assets of that corporation's subsidiaries.

The court again agreed with Kingsway, holding that Kingsway America Inc. (a U.S. holding company of Kingsway) transferred its Walshire stock to 20 charities and Kingsway America Inc. is a Delaware corporation, not a domestic insurance company.

Deference vs. Plain Meaning

The PID seems to have anticipated that its positions were not among the strongest since it also argued that the court should give deference to the PID's views, citing a Pennsylvania court ruling granting deference to an agency's administrative discretion in interpreting legislation within such agency's own sphere of expertise absent fraud, bad faith, abuse of discretion or clearly arbitrary action. In response, Kingsway urged the court to interpret all these Pennsylvania laws consistent with their plain meanings. Furthermore, Kingsway argued that the deference rule cited by the PID applied to the PID only in its rulemaking capacity; since the interpretation of laws in this matter did not involve rulemaking, the PID's views should not be applied since they were erroneous.

In its holding, the court gave no express deference to the PID's views and focused solely on the statutory wording – in each case citing the applicable statute and stating, in a short sentence or two, why the statute did not apply to the facts presented. ■

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Broker-Dealer Fined for Allowing a Highly Sophisticated Data Intrusion Process to Penetrate the Firm's Systems and to Access Customer Data

by Satish M. Kini and Thomas S. Wyler

In a case that reads like a TV crime drama, on April 12, 2010, the Financial Industry Regulatory Authority ("FINRA") announced a $375,000 fine against a member firm, D.A. Davidson & Co. ("Davidson"), for failing to protect its customers' confidential information. Davidson's computer systems were hacked by a Latvian-based crime group, who hijacked the firm's data on Christmas Day and then attempted to blackmail the firm for the data's return.

The hacking took place on December 25 and 26, 2007. The criminals used a sophisticated network intrusion mechanism called a "structured query language" injection, in which computer code is repeatedly inserted into a web page to extract information from a database. By this means, the criminals were able to access and download customer data stored on Davidson's computer systems; the hackers successfully downloaded the confidential information of 192,000 individual Davidson customers.

The attacks were not discovered until January 16, 2008, when the hackers sent Davidson an email in an effort to blackmail the firm. The criminals apparently demanded $80,000 from Davidson in exchange for not disclosing Davidson's security vulnerabilities and for destroying the confidential information stolen from Davidson's computer systems.

When it received the threat, Davidson promptly took down its website and reported the security breach to law enforcement. The firm then cooperated with federal law enforcement and assisted the Secret Service to identify four members of the group suspected of participating in the attack. Three of the group's members were apprehended by Dutch police in the Netherlands, when, according to press reports, the hackers attempted to pick up the money they had demanded from Davidson. The three individuals were subsequently extradited to the United States, where they pled guilty to attempted extortion in a federal court.

The case also evidences the increasingly heightened regulatory expectations regarding the types of policies, procedures and systems that firms must maintain to protect customer confidential information....

Davidson also took other steps in the immediate wake of the incident. It issued a press release to the public reporting the incident and prepared a detailed communication plan for its employees. Davidson also hired an outside firm to advise on electronic security, added additional firewall protection between the Internet and the firm's internal systems and installed intrusion protection software. To date, according to FINRA, no customers of the broker-dealer have suffered any instances of identity theft as a result of the security breach.

FINRA, while acknowledging the firm's quick response once it learned of the incident and crediting Davidson for its cooperation with law enforcement, fined the firm for failing to maintain adequate data safeguards. According to FINRA, the firm lacked written procedures to require a review of its web server logs, which review would have revealed the intrusion (instead of permitting it to go undetected for several weeks). FINRA also noted that, between April 2006 and October 2007, Davidson had, at various times, retained auditors and independent security consultants to review its network security systems and procedures. The firm implemented the majority of the recommendations made by those auditors and consultants, but Davidson failed to implement at least one key recommendation: installing an intrusion detection system.

According to FINRA, these various control deficiencies allowed the hackers to breach the firm's system and obtain the customer's confidential information. Specifically, FINRA found that exposing the firm's database "to a persistent Internet connection" without

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installing password protections or data encryption was an unreasonable failure of data security and a violation of Rule 30 of Regulation S-P, which requires broker-dealers and other SEC-regulated entities to install systems and procedures reasonably designed to safeguard customer information. Without the proper security systems, customer's confidential information was thus both accessible to and readable by hackers. Further, FINRA stated that, given that an outside security consultant recommended an intrusion detection system and that Davidson reasonably should have known that its database was exposed through the website, the breach was indicative of a failure to install reasonably designed customer security measures. Put differently, notwithstanding the firm's self-reporting and other *ex post* mitigating factors, Davidson failed to properly secure the confidential information of its clients.

In addition to paying the FINRA fine, Davidson faced and apparently settled a consumer class-action lawsuit. According to press reports, the firm settled the lawsuit by agreeing, among other things, to make available (1) a credit monitoring program to customers that monitors customers' credit reports daily and alerts them of indicators of possible identity theft and (2) up to $750,000 to reimburse class members who can prove identity theft losses, with a limit of $10,000 per member.

This incident serves as another warning of the potentially serious consequences of a data security breach in terms of regulatory penalties, customer lawsuits and, most importantly, reputational damage. The case also evidences the increasingly heightened regulatory expectations regarding the types of policies, procedures and systems that firms must maintain to protect customer confidential information (even from advanced data breach schemes). This case also demonstrates that there are currently two critical components to data protection: (1) the safety measures designed to prevent security breaches, and (2) the compliance procedures designed to respond in the event that they occur. Although, according the FINRA, Davidson may have been deficient in the former, the firm's response to the breach was excellent, which lessened the potential consequences of this breach. ■

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New Basel Capital Proposal

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New Common Equity Requirement

Most of the criticism has centered around the Capital Proposal's new requirement that common equity, after the application of regulatory adjustments, serve as the predominant form of Tier 1 capital. The Capital Proposal would set a new minimum requirement for such common equity (in addition to the requirements for total Tier 1 and total capital, as well as a new leverage ratio). Common equity would include only common shares (or their equivalent for non-stock companies), plus retained earnings and other comprehensive income.

This common equity measure would also be subject to a number of "regulatory adjustments," *i.e.* deductions for, among other things, deferred tax assets, minority interests, intangible assets (including mortgage servicing rights) and investments in own shares (treasury stock) and in other financial institutions. These regulatory adjustments to the common equity measure received perhaps the lion's share of criticism, including that a full deduction approach fails to fairly recognize the value of certain assets and that the adjustments in some cases could increase pro-cyclicality.

In addition to the regulatory adjustments, the requirement that only common shares and retained earnings serve as the predominant form of Tier 1 capital and other limitations on Tier 1 capital were criticized as overly restrictive with respect to hybrid instruments that may serve to absorb losses, such as trust preferred securities. The Basel Committee has indicated that there may be flexibility for grandfathering certain instruments as part of the transition.

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Leverage Ratio

The Basel Committee also proposed the introduction of a new leverage requirement globally. Criticism of the new leverage ratio focused not only on its lack of risk-sensitivity, but also on the inclusion in the denominator of certain off-balance-sheet items not currently included in the U.S. leverage ratio and which would not recognize certain collateral, guarantee and netting arrangements.

Additional Capital Buffers and Surcharges

In addition to the increased capital necessitated by the new rules discussed above, the Capital Proposal also suggests, as a counter-cyclical safeguard, that institutions should hold capital buffers above the regulatory Tier 1 minimum. The buffers could be adjusted upward in periods when regulators determine there is excessive credit growth and drawn down in times of stress. Falling below the buffer would subject an institution to limits on its ability to pay dividends, buy back shares, and pay bonuses.

Moreover, the Capital Proposal also indicated that the Basel Committee would consider a capital surcharge on systemically important institutions, as has been proposed in regulatory reform legislation in the United States. Such buffers and surcharges could result in even higher layers of requirements on the largest and most inter-connected institutions. Many observers have raised concerns that the various layers of new requirements — including those emanating from the Basel Committee and those being undertaken by individual countries — need to be coordinated and their cumulative impact needs to be considered in the context of a fragile global economic recovery.

Although not yet finalized, the Capital Proposal appears likely to significantly increase the capital requirements of financial institutions, and in particular to require the raising of substantial new common equity.

Expanding Risk Coverage

Some estimate that the bulk of the impact of the new capital requirements will come from the requirements for a new core capital base, discussed above. But additional capital would also be required by other proposed expansions of risk coverage for counterparty credit risk exposures arising from derivatives, repurchase agreements and securities financing activities. These changes include requirements for the use of stressed inputs for counterparty credit risk, a credit valuation adjustment to reflect mark-to-market losses (short of actual default) associated with the creditworthiness of a counterparty and charges to encourage central clearing of derivative transactions. These proposed changes would be in addition to changes the Basel Committee completed in July 2009 to raise capital requirements for trading book and complex securitization exposures. Among other criticisms, commentators have noted that the latest proposals would benefit from experience with the July 2009 reforms before layering on additional requirements.

Conclusion

Although not yet finalized, the Capital Proposal appears likely to significantly increase the capital requirements of financial institutions, and in particular to require the raising of substantial new common equity. The Capital Proposal also makes clear that institutions are likely to face numerous new requirements that will be layered on top of one another. Although several concerns with specific aspects of the Capital Proposal have been raised, it remains to be seen the extent to which the Basel Committee will modify the Capital Proposal as initially submitted, or build in mitigating transition periods or potential flexibility through grandfathering arrangements. ■

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