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Steven A. Meyerowitz

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# THE BANKING LAW JOURNAL

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VOLUME 125

NUMBER 6

JUNE 2008

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## PRIVATE MONEY, PUBLIC RULES

STEVEN A. MEYEROWITZ

Private-equity investments in banking organizations are becoming more and more common, and appear to be driven by two factors that are in some ways related, as explained by Jeffrey L. Hare of Alston & Bird and law clerk Christopher N. Steelman in the lead article in this issue, “When Private-Equity Meets Banks: The Impact Of Banking Regulations On Private-Equity Investment.”

First, the authors note, the value of many banking organization stocks is highly volatile as quarterly reports for some institutions reflect rapidly rising delinquency rates and corresponding pressures to supplement reserves. Analysts, and likely private-equity fund managers, have equally volatile valuations of banking organizations. Under these conditions, there is potential to identify undervalued institutions that are being punished for market-wide reaction to subprime and other credit-related matters—reactions that may not necessarily be supported by the risks inherent in a given institution’s balance sheet.

Second, a need for capital during a time when the markets and exchanges view financial stocks with skepticism and unease has caused banking organizations to look to alternative sources, such as private-equity, to meet their capital needs. Generically, banking organizations are looking for capital to remain well capitalized in the face of write-downs on loan portfolios and increases in loss reserve accounts in anticipation of future write-downs.

Whatever the driving forces may be, Messrs. Hare and Steelman believe that private-equity firms targeting banking organizations for investment and banking organizations seeking to obtain private-equity investment face

unique considerations arising from the highly regulated environment in which banks operate.

In their article, the authors identify significant regulatory issues that may impact the character, amount, or structure of a private-equity firm's investment in a banking organization. As the authors explain, notwithstanding those regulations, if structured appropriately and the applicable regulatory limitations and implications are fully addressed along with the economic or business considerations, private-equity investments in banking organizations can often prove to be a workable and beneficial option for all involved.

### And More....

We have more for you in this issue, including a "Directors' Perspective" column by Christopher J. Zinski, General Counsel of PrivateBancorp, Inc., a bank holding company that owns five bank subsidiaries operating under the name "The PrivateBank," and a "Technology, Law, and Banking" column by James F. Bauerle, director of Legal and Business Services of Keevican Weiss Bauerle & Hirsch LLC and FiCap Strategic Partners LLC, a consulting firm that exclusively serves financial institutions.

Enjoy the issue!

Steven A. Meyerowitz  
Editor-in-Chief  
April 2008

# WHEN PRIVATE-EQUITY MEETS BANKS: THE IMPACT OF BANKING REGULATIONS ON PRIVATE-EQUITY INVESTMENT

JEFFREY L. HARE AND CHRISTOPHER N. STEELMAN

*Private-equity transactions with banking organizations continue to emerge and even grow in frequency, both for economic reasons, and, in some cases out of necessity for increased capital. If structured appropriately and the applicable regulatory limitations and implications are fully addressed along with the economic or business considerations, private-equity investments in banking organizations can often prove to be a workable and beneficial option for all involved.*

In light of the growing economic importance of private-equity firms in the market and their ever-increasing appetites for acquisition targets, banking organizations cannot ignore the potential for investment or acquisition by private-equity. Generally, private-equity investments in banking organizations can be divided into two categories:

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1. *General Funds*. Investments by funds that acquire stakes in diverse companies that conduct a variety of activities, including retail, manufacturing, health care, etc. (“General Funds”); and
2. *Bank-Focused Funds*. Investments by funds that focus exclusively on acquisition targets whose business is banking and bank-related products and services — in other words, activities permissible for banks or bank holding companies (“Bank-Focused Funds”).<sup>1</sup>

Bank-Focused Funds are often registered as (or willing to register as) bank holding companies and comply with the significant regulatory implications inherent in such registration. By contrast, General Funds are necessarily unable and unwilling to comply with bank holding company regulations; thus, they must limit their banking organization investments to non-controlling interests.

## RECENT EXAMPLES OF PRIVATE EQUITY INVESTMENTS

Recent examples of private-equity investment transactions fall within both of these categories. First, the HSH Nordbank deal led by the private-equity firm J.C. Flowers & Co. in September 2006; Citadel Investment Group’s investment in E\*TRADE Financial Corporation in November 2007; the Doral Financial Corp. deal led by Bear Stearns Merchant Banking<sup>2</sup> in July 2007; and the recent acquisition of up to 25 percent of the common stock of Washington Mutual, Inc. by the TPG Group in April 2008 involve General Funds acquiring a significant, but non-controlling, stake in banking organizations. Second, Bank-Focused Fund transactions such as the acquisition of 67 percent of Spectrum Bank by Belvedere Capital, an existing bank holding company, in November 2007; CapGen Capital Group’s registration as a bank holding company and acquisition of a controlling interest in Bank Brevard and BankFirst in September 2007; and BankCap Partners’ registration as a bank holding company and acquisition of 30 percent of Atlantic Capital Bank<sup>3</sup> in May of 2007 provide examples of private-equity funds acquiring controlling investments in banking organizations. These transactions confirm that private-equity is a viable source of capital for banking

organizations. In fact, John M. Reich, Director of the Office of Thrift Supervision, recently issued an invitation to private-equity firms to invest in savings associations, noting that firms can make more capital available to savings associations, identify institutions with growth prospects and cultivate that growth and even revive struggling institutions. Mr. Reich said, “[t]he Office of Thrift Supervision is open to listening to the ideas and strategies of fund managers as potential owners of savings banks.”<sup>4</sup>

Private-equity investments in banking organizations appear to be driven by two factors that are in some ways related. First, the value of many banking organization stocks is highly volatile as quarterly reports for some institutions reflect rapidly rising delinquency rates and corresponding pressures to supplement reserves. Analysts, and likely private-equity fund managers, have equally volatile valuations of banking organizations. Under these conditions, there is potential to identify undervalued institutions that are being punished for market-wide reaction to subprime and other credit-related matters — reactions that may not necessarily be supported by the risks inherent in a given institution’s balance sheet. Second, a need for capital during a time when the markets and exchanges view financial stocks with skepticism and unease has caused banking organizations to look to alternative sources, such as private-equity, to meet their capital needs. Generically, banking organizations are looking for capital to remain well capitalized in the face of write-downs on loan portfolios and increases in loss reserve accounts in anticipation of future write-downs. Whatever the driving forces may be, both private-equity firms targeting banking organizations for investment and banking organizations seeking to obtain private-equity investment face unique considerations arising from the highly regulated environment in which banks operate.

## RELEVANT TERMINOLOGY

Because the regulatory framework as well as the appropriate agencies differ materially between banks, thrifts and their respective holding companies, it is often important to identify the type of banking organization at issue. When possible, the term “banking organization” is used to refer generically to all types of institutions and holding companies; however, specific terminology is used when a distinction is necessary in order to differentiate

between the types of institutions and the associated regulatory implications.

## State Bank

A state bank is chartered and regulated by the appropriate state bank regulator and by the Federal Reserve Board (the “Fed”), in the case of Fed member banks, or the Federal Deposit Insurance Corporation (the “FDIC”), in the case of non-member banks.<sup>5</sup>

## National Bank

A national bank is chartered and regulated by the Office of the Comptroller of the Currency (the “OCC”) and secondarily by the FDIC.

## Federal Savings Bank

A federal savings bank, savings association, or thrift is chartered and regulated by the Office of Thrift Supervision (the “OTS”) and secondarily by the FDIC.

## Bank Holding Company

A bank holding company is generally a Fed-regulated company that has *direct or indirect* control of a state bank or national bank.

## Financial Holding Company

A financial holding company is an eligible bank holding company that elects to be treated as a financial holding company by the Fed and thereby gains the ability to engage in an expanded list of permissible activities, as discussed herein.

## Savings and Loan Holding Company

A savings and loan holding company is an OTS-regulated company that

has *direct or indirect* control of a federal savings bank, savings association, or thrift.

## CONTROL THRESHOLDS

In the highly regulated environment in which banking organizations operate, an economic determination as to the benefits of a given investment must necessarily be weighed against regulatory considerations. Unlike when a private-equity fund obtains a significant stake in a retailer or manufacturer, controlling investments in banking organizations trigger review by (and often approval from) federal and sometimes state bank regulators. Regulatory scrutiny may include a safety and soundness assessment, consideration of the management team and financial resources of the acquirer and approval of any change in control. Changes of control may arise at different thresholds depending on the type of banking organization and the indicia of control that the acquirer exercises or has the ability to exercise. Thus, the control thresholds are very relevant considerations at the outset of a potential investment.

Once a private-equity firm obtains a controlling interest — usually based on a percentage of equity ownership, some form of control over management or the banking organization's strategies and objectives, or some combination of both — the firm itself becomes a bank holding company or a savings and loan holding company, as the case may be. As such, it becomes subject to various regulatory and reporting requirements, as well as activities limitations. Depending on how a firm is structured and the investment objectives it has disclosed to investors (e.g., General Funds versus Bank-Focused Funds), these requirements may be, and in most cases are, of sufficient impact so as to dissuade it from acquiring a controlling interest. In most cases, a General Fund will be prevented from becoming a holding company because of these regulatory restrictions. Banking regulation will likely impact the amount of the investment, the structure of the investment and whether its shareholders are fully informed of the potential consequences. Such considerations may add costs to the investment, delay timing, or run counter to the investment strategy of the fund.

Most, but not all, of the substantive regulatory implications associated with investments in banking organizations are triggered when the investing

party's ownership reaches a specified level at which point it is deemed to control the institution. Under the Bank Holding Company Act,<sup>6</sup> an investor's direct or indirect ownership of less than five percent of the voting stock of a state bank or national bank is deemed to be a non-controlling interest and further consideration is not needed. An investor that directly or indirectly (i) owns 25 percent or more of the voting stock; (ii) controls in any manner the election of a majority of the directors; or (iii) exercises a controlling influence over the policies or management of a state bank or national bank conclusively controls the institution and is therefore subject to regulation as a bank holding company.<sup>7</sup> Ownership of five percent or more, but less than 25 percent, of the voting stock creates a rebuttable presumption that the investor controls the institution. Control factors that the Fed may take into consideration within this rebuttable presumption range include the percentage of voting and nonvoting equity investments, board seats, or power to elect board members, voting agreements and other indicia of control.

The Fed may also find that control exists when an investor acquires non-voting securities, including non-voting preferred stock and convertible stock, in a state bank or national bank.<sup>8</sup> Non-voting securities will be viewed in light of the totality of factors surrounding the nature and character of the investment to determine whether in fact the investment constitutes control subject to regulatory oversight. To this end, the Fed considers factors such as (i) the number of banking organizations in which the investor owns an interest; (ii) the level of involvement the investor has in directing the activities of management or establishing an institution's policies as a result of the investment; and (iii) the terms of any ancillary financial arrangements by and between the institution and the investor.

As compared to the Bank Holding Company Act, the Home Owners' Loan Act<sup>9</sup> creates a similar, but slightly different, regimen for determining control in a savings association. OTS control regulations<sup>10</sup> provide that an investor's interest is non-controlling if it is less than 10 percent of the voting stock. An investor is deemed to *conclusively* control a federal savings association when it directly or indirectly:

- acquires more than 25 percent of any class of voting stock or proxies;
- controls the election of a majority of directors;

- has contributed more than 25 percent of the equity capital of the savings association or its holding company; or
- is a trustee of a trust that meets any of the foregoing criteria.

An investor is presumed, subject to rebuttal, to control a federal savings association, in part, when it acquires more than 10 percent of any class of voting stock or more than 25 percent of any class of non-voting stock and is subject to any control factor. Control factors include:

- being one of the two largest shareholders;
- holding more than 25 percent of total shareholders' equity;
- holding more than 35 percent of combined debt securities and shareholders' equity;
- being a party to certain agreements pursuant to which an investor possesses a material economic stake in the savings association or may influence a material aspect of its management or policies;
- having more than one member of the board of directors; and
- serving as or appointing the chairman or certain key executives.

## REBUTTAL PRESUMPTION OF CONTROL

Investors within the range for a rebuttable presumption of control may negotiate and enter into certain passivity or rebuttal of control agreements with the Fed or the OTS, as appropriate, whereby they commit to forego actions that may result in the exercise of control. While mechanistic in format and content, there is generally room for fact-specific provisions in such commitments. Some examples of standard commitments required under a rebuttal of control agreement are that:

1. The investor will not seek or accept representation of more than one member of the board of directors;
2. The investor's board designee will not seek to serve as the chairman of

- the board of directors, chairman of the executive committee or similar committee, or act as president or chief executive officer;
3. The investor will not engage in any intercompany transactions with the banking organization or its affiliates;
  4. The investor will not propose a director in opposition to nominees proposed by management; and
  5. The investor will not solicit proxies with respect to any matter presented to the shareholders other than in support of, or in opposition to, a solicitation conducted on behalf of management.<sup>11</sup>

These restrictions, among others, associated with a rebuttal of control agreement are intended to limit the ability of an investor to actively alter the strategy of the banking organization, influence management, or engage in anything other than passive investment. The arguments asserted and commitments offered to rebut a presumption of control are, by nature, very fact-specific. As the OTS notes:

[the] OTS may reject any control rebuttal that is inconsistent with the facts and circumstances known to [the OTS], or which does not clearly and convincingly rebut the presumption of control. If OTS concludes that it would be injudicious to rely on an acquiror's representation, based on past activities of the acquiror, or other concerns, OTS may conclude that the acquiror has not clearly and convincingly rebutted a determination of control.<sup>12</sup>

Acceptance of rebuttal commitments is generally premised on the regulator's determination that a particular investment is "made for investment purposes with the expectation of resale and not for the purpose of exercising a controlling influence over the management or policies of a [banking organization]."<sup>13</sup>

## ACTING IN CONCERT

Banking regulations also establish a mechanism to recognize shared control by related parties acting in concert. These regulations presume, subject

to rebuttal, that certain related or affiliated investors are acting in concert to exercise control, even where an individual investor's stake alone is below the control threshold. The effect of a presumption of concerted action is that ownership interests are aggregated. Acting in concert involves knowing participation in a joint activity or parallel action towards a common goal of acquiring control of a banking organization, whether or not such action or conduct is pursuant to an express agreement.<sup>14</sup> As with the control thresholds, presumptions of concerted action may be rebutted through commitments with the appropriate regulators.

The concept of concerted action should be of particular concern for those private-equity deals that are structured as "club deals" involving multiple funds. Each fund's investment is separate; however, the simultaneous nature of the investments and possible side agreements to vote collectively could raise questions of concerted action. Such issues should be addressed early in the process of structuring any club deal involving a banking organization.<sup>15</sup>

Bank regulatory control involves a complicated mixture of formulaic determinations and subjective assessments that have significant implications for any private-equity firm considering a sizeable investment in a banking organization as well as any banking organization seeking private-equity investments. The nature, character and structure of a private-equity investment transaction must take into account the thresholds and implications of "control."

## REGULATORY ISSUES GERMANE TO PRIVATE-EQUITY INVESTMENTS IN BANKING ORGANIZATIONS

As noted, General Funds will not likely be able to become holding companies because of the regulatory environment of banking organizations. The restrictions, limitations, and obligations run counter to, and in some instances are incompatible with, a General Fund's investment goals, objectives and strategies.

This is not to say that a General Fund is precluded from investing in banking organizations. Rather, the fund must be mindful of the regulatory issues described below and the investment must be carefully structured in order to ensure that the transaction does not trigger the control thresholds and that rebuttal agreements are in place with the appropriate regulators.

## CONCERNS FOR PRIVATE-EQUITY FIRMS

A private-equity firm that makes a controlling investment in a banking organization becomes a bank holding company if it invests in a national bank or state bank, or a savings and loan holding company if it invests in a federal savings association. Regulatory implications of such designations are quite significant. The following list identifies a few of the more relevant implications.

### Prior Approvals

Prior to becoming a bank holding company or a savings and loan holding company, a private-equity firm and certain of its executive management and principals must file applications with the Fed or the OTS, as the case may be, to obtain approval to become a holding company. The application is accompanied by public notice and a public comment period. The investment horizon of many private-equity funds is limited to ten years or less, which means that changes of control are likely to occur with greater frequency, forcing the approval periods and related costs to play a role in acquisitions or divestitures.

### Permitted Activities and Investments

If a private-equity firm were to become a bank holding company, its activities and investments would generally be limited to those that the Fed has determined by regulation or order to be so closely related to banking or managing or controlling state banks and national banks as to be a proper incident thereto. A bank holding company may elect to become a financial holding company, thereby expanding the scope of permissible activities to generally encompass certain insurance and securities-related activities. Such an election is permitted when all banks, domestic and foreign, controlled by a bank holding company (i) are and remain both “well capitalized” and “well managed,”<sup>16</sup> if applicable; and (ii) have received a “satisfactory” or better rating in their most recent Community Reinvestment Act examination. Savings and loan holding companies are permitted to engage in the expand-

ed powers available to financial holding companies; however, no election is required. A General Fund's other investments and investment strategies would generally conflict with the regulatory restrictions on permitted activities and investments.

### Source of Strength Doctrine

The Fed policy that a bank holding company is expected to act as a source of financial strength to its subsidiary banks and to commit resources to support the banks may conflict with the strategies of a private-equity fund. The Fed takes the position that the source of strength doctrine may require a bank holding company to provide support when the holding company otherwise may not consider itself able to do so. Bank holding companies must stand ready to provide capital to a subsidiary bank during periods of financial stress or adversity generally or for the subsidiary bank specifically. If a bank holding company were not able or willing to satisfy such obligation then the holding company may be required to divest its interest in the bank. A comparable doctrine does not exist for savings and loan holding companies. Nonetheless, the OTS assesses the overall holding company enterprise as reflected by its organizational structure, risk management, capital, and earnings. In so doing, it places significant importance on the effect a savings and loan holding company has on its subsidiary institution.<sup>17</sup>

### Minimum Capital Requirements

Bank holding companies are required to satisfy several measures adopted by the Fed to assess their capital adequacy, including measures to establish minimum capital requirements in relation to assets and various off-balance sheet risk exposures. Failure of a bank holding company to meet or exceed requisite capital levels may result in the subsidiary bank paying higher deposit insurance premiums to the FDIC or other penalties. While savings and loan holding companies do not have specific capital requirements, the OTS evaluates "capital adequacy relative to a given enterprise's risk profile."<sup>18</sup> The concept of being told what levels of capital to maintain and possibly even when to deploy the capital for the benefit of a subsidiary bank is incon-

sistent with most private-equity funds' practices and policies as disclosed to its shareholders or investors.

## Dividends and Distributions

The Fed, OTS, OCC, and FDIC all have policies generally prohibiting distributions in excess of net income for banking organizations experiencing earnings weakness. Additionally, the Fed and the OTS possess enforcement powers over holding companies and their non-bank subsidiaries to proscribe the payment of dividends. One source of partial liquidity for some General Funds is to complete a dividend recapitalization, which is much less feasible for banking organizations.

## Transactions with Affiliates

Transactions between an institution and its holding company or other subsidiaries of the holding company are subject to restrictions on affiliated transactions.<sup>19</sup> Such transactions include loans and other extensions of credit, purchases of securities, and other assets, provision of services and payments of fees. In general, these restrictions limit the terms and amounts of transactions between an institution and its affiliates, both individually and in the aggregate, impose collateralization requirements on extensions of credit and require arms' length terms. Compliance with these rules would be required for any transactions between an institution and its private-equity firm parent or between the institution and other companies owned by the private-equity firm.

Other regulatory considerations that a private-equity firm may encounter if it obtains a controlling interest in a banking organization include fairly broad regulatory enforcement authority for violations of laws and regulations as well as periodic reporting and examination obligations. Also, firms that find themselves in control of more than one banking organization should recognize that under Section 5 of the Federal Deposit Insurance Act,<sup>20</sup> the FDIC may impose "cross-guarantee" liability upon commonly controlled insured depository institutions (either banks or savings associations) for deposit insurance losses incurred by the FDIC.

## CONCERNS FOR BANKING ORGANIZATIONS

When a banking organization requests or invites private-equity investment, it should take into account a number of considerations.

### Capital Treatment

A primary concern for banking organizations seeking private-equity investment will be to ensure that any transaction is structured in a manner that allows it to treat incoming consideration as qualifying capital to satisfy its capital adequacy needs. For example, the maximum amount of Tier 2 capital that may be recognized for risk-based capital purposes is 100 percent of Tier 1 capital (after any deductions for disallowed intangibles and disallowed deferred tax assets), and the combined amount of term subordinated debt and intermediate-term preferred stock that may be treated as part of Tier 2 capital for risk-based capital purposes is 50 percent of Tier 1 capital. Amounts in excess of these limits are not included in the calculation of the risk-based capital ratio.<sup>21</sup>

### Risk Assessment

A related point will be the need to pay careful attention to those rights, assets, or instruments that it gives to the private-equity firm in return for the capital infusion. Although largely an economic or business determination (as opposed to a regulatory consideration), factors such as the risk associated with the issuance of debt or equity should be considered.

### Investor Motivations

Another important concern is to have a thorough and complete understanding of the private-equity firm, its objectives and strategies, and the role it seeks to play if it becomes a controlling shareholder of the banking organization or a non-controlling investor. As noted, many General Funds will not seek control in a banking organization, largely due to the associated non-bank investment and activity limitations imposed under the auspices of fed-

eral regulation (at least not control as defined by applicable banking laws and regulations). However, significant investors that do not technically control a banking organization may still wield influence and authority in terms of major business decisions, management succession, and long-term strategic planning. Significant non-controlling investors may also seek to obtain a representative on the board of directors.

When a private-equity firm's stake rises to the level of a rebuttal presumption of control, the banking organization may look to the investor's rebuttal of control or passivity agreements with the regulators approving the transaction to ensure that the institution can expect to continue to operate in accordance with its long-term goals and strategies. Conversely, if a Bank-Focused Fund seeks to gain control of a banking organization, the banking organization should ensure that its objectives comport with those of the firm and that the institution's safe and sound operations and level of customer service can be expected to continue or improve as a result. These factors will necessarily be considered by the appropriate regulators; however, the banking organization would be well served to conduct its own assessment.

## CONCLUSION

Banking organizations operate in a highly regulated environment and are subject to extensive federal (and in some cases state) legal and regulatory limitations. This article has identified certain significant regulatory issues that may impact the character, amount, or structure of a private-equity firm's investment in a banking organization. Notwithstanding those regulations, private-equity transactions with banking organizations continue to emerge and even grow in frequency, both for economic reasons, and, in some cases out of necessity for increased capital. If structured appropriately and the applicable regulatory limitations and implications are fully addressed along with the economic or business considerations, private-equity investments in banking organizations can often prove to be a workable and beneficial option for all involved.

## NOTES

<sup>1</sup> While not discussed in detail in this article, securities disclosures of Bank-Focused Funds must describe the nature and implications of controlling investments in banking organizations, including disclosures that such investments would be subject to prior approvals and that the fund would be subject to extensive legal and regulatory restrictions and limitations.

<sup>2</sup> In coordination with Bear Stearns Merchant Banking, each of Perry Capital, Marathon Asset Management, Tennenbaum Capital Partners and D. E. Shaw & Co. acquired between 9.1 and 9.5 percent of the total equity and between 9.6 and 9.9 of the voting securities of Doral Holdings, which in turn owns approximately 90 percent of Doral Financial. The Federal Reserve approved these acquisitions as non-controlling investments. See Federal Reserve Board General Counsel Opinion, Scott G. Alvarez (July 18, 2007).

<sup>3</sup> During formation, Atlantic Capital Bank raised over \$125 million in equity capital, making it the largest, independent *de novo* bank formed in the United States.

<sup>4</sup> John M. Reich, *Viewpoint: Private Equity, Welcome to the World of Thrifts*, AM. BANKER, Jul. 27, 2007, at 11.

<sup>5</sup> State banks may elect to be either a Fed member bank or a non-member bank. An election to be a Fed member bank makes the Fed the primary federal regulator with the FDIC as the secondary federal regulator, election to be a non-member bank makes the FDIC the primary federal regulator through its role as the deposit insurer.

<sup>6</sup> 12 U.S.C. §§ 1841-1850 (2005).

<sup>7</sup> 12 C.F.R. § 225.2(e) (2007).

<sup>8</sup> 12 C.F.R. § 225.143 (2007).

<sup>9</sup> 12 U.S.C. §§ 1461-1470 (2005).

<sup>10</sup> 12 C.F.R. § 574.4 (2007).

<sup>11</sup> See 12 C.F.R. § 574.100 (2007).

<sup>12</sup> OFFICE OF THRIFT SUPERVISION, OTS ORDER NO. 2008-02, APPROVAL OF REBUTTAL OF CONTROL 2 (January 18, 2008), *available at* <http://www.ots.treas.gov/docs/6/680002.pdf>.

<sup>13</sup> FEDERAL RESERVE BOARD, LEGAL INTERPRETATION TO THE CAPITAL GROUP COMPANIES, INC. (Aug. 13, 2002), *available at* [http://www.federalreserve.gov/boarddocs/legalint/BHC\\_ChangeInControl/2002/20020813/](http://www.federalreserve.gov/boarddocs/legalint/BHC_ChangeInControl/2002/20020813/).

<sup>14</sup> 12 C.F.R. §§ 225.41(b)(2), 574.2(c) (2007).

<sup>15</sup> The Federal Reserve Board did not find concerted action to exist in the Doral Financial club deal, in part, because the various funds were not affiliated, independently reached a decision to invest, had no side agreements and agreed not to con-

sult with others when voting. *See* Federal Reserve Board General Counsel Opinion, Scott G. Alvarez (July 18, 2007). Multiple affiliated investors were presumed to be acting in concert for the investment in Washington Mutual, Inc. by the TPG Group. Office of Thrift Supervision, OTS Order No. 2008-08, Approval of Rebuttal of Control (April 7, 2008).

<sup>16</sup> A domestic bank is well capitalized if it has a total risk-based capital ratio of 10 percent or greater, has a Tier 1 risk-based capital ratio of six percent or greater, has a leverage ratio of five percent or greater and is not subject to any written agreement, order, capital directive or prompt-corrective-action directive to meet and maintain a specific capital level. Generally a domestic bank is well managed if, at its most recent exam or subsequent review, the bank received at least a “satisfactory” composite rating and at least a “satisfactory” rating for management, if such rating is given. The requirements for a foreign bank to be well managed and well capitalized differ depending on the jurisdiction in which the bank is formed.

<sup>17</sup> 72 Fed. Reg. 72,442, 72,443 (December 20, 2007) (“The [holding company]’s effect on its thrift subsidiary will continue to be an important consideration in the examination process....”).

<sup>18</sup> *Id.*

<sup>19</sup> *See* 12 U.S.C. §§ 371c, 371c-1 (2005). These two sections dealing with transactions with affiliates are made applicable to federal savings associations by 12 U.S.C. § 1468 (2005).

<sup>20</sup> 12 U.S.C. § 1815(e) (2005).

<sup>21</sup> 12 C.F.R. Part 325 app. A (2007).

# IS THE DUAL BANKING SYSTEM OBSOLETE? NEW YORK'S STREAMLINED APPROVAL FOR NATIONAL BANK ACTIVITIES

ERNEST T. PATRIKIS, GLEN R. CUCCINELLO AND RANDI MAIDMAN

*The authors review the impact of changes to New York's "banking wild card" statute.*

New York State amended its banking wild card statute, effective September 1, 2007, to greatly simplify the process by which New York-chartered banks can apply for a variety of powers otherwise only available for national banks.<sup>1</sup> This new statute enables the New York State Banking Board to grant by resolution, after review of a simple application, state-chartered banks, and state-licensed foreign bank branches and agencies the same powers possessed by counterpart national banks and federally licensed branches and agencies of foreign banks.<sup>2</sup> Previously, wild card powers could be adopted only by regulation, a far more time-consuming process.

## WHY NEW YORK NEEDED A NEW WILD CARD STATUTE

Under the United States' dual banking system, banks have a choice of being chartered either nationally or by a particular state. Where a bank receives its charter determines which agency is responsible for overseeing and regulating the bank. If a bank is nationally chartered, it is examined and reg-

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ulated by the Office of the Comptroller of the Currency (“OCC”), a bureau of the Department of the Treasury. Nearly all state-chartered banks are examined and regulated, on the federal level, by either the Federal Reserve Board or the Federal Deposit Insurance Corporation (“FDIC”), as well as by the chartering state’s banking department.

The continued viability of the dual banking system has, in recent years, been called into question by the conversions to national charter of several of the largest state-chartered banks in the industry. This migration from state to federal charter appears to have been the product of two interrelated regulatory developments — the assertion by the OCC (and the upholding by the courts) of federal preemption of state laws purporting to regulate the business operations of national banks, and the expansion of the scope of activities permissible for national banks and their subsidiaries as a result of amendments by the Gramm-Leach-Bliley Act of 1999 (“GLB Act”) to the National Bank Act and a large number of expansive interpretations of the latter Act by the OCC. These charter conversions have taken place notwithstanding the fact that the examination costs paid by state banks are significantly lower than those paid by national banks.

The preemption issue began in 1994 when barriers to interstate expansion of banks were lifted with the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act. As out-of-state branches grew, banks found themselves subject to the varying (and often contradictory) regulations of each and every state in which they operated, as well as federal regulations.

The OCC took the position, which it continues to hold, that nationally chartered banks’ banking activities are exempt from state banking laws and regulations, subject to certain exceptions.<sup>3</sup> Preemption makes having a national charter quite attractive to many banks, as it substantially reduces the costs, complexity, and regulatory risks of doing business on a nationwide basis, but is troublesome for states, particularly because the OCC takes the position that its regulations preempt even state laws dealing with issues of fair lending and consumer protection.<sup>4</sup>

The expansion of national bank powers has also been a relatively recent development. Although the National Bank Act historically has not differed dramatically, in terms of bank powers, from the New York Banking Law, the GLB Act amended the National Bank Act to permit a national bank meet-

ing certain criteria and requirements to establish one or more financial subsidiaries that may engage in a wide range of activities, some of which would be *ultra vires* if conducted within the bank itself.<sup>5</sup> These activities include, among other things:

- underwriting, dealing and making a market in all types of securities;
- brokering or acting as agent for insurance and annuities in any state;
- nonbanking activities permitted by the Federal Reserve Board for bank holding companies as “closely related to banking” and foreign activities permitted as usual in connection with the transaction of banking or other financial operations abroad; and
- other activities that the Secretary of the Treasury in consultation with the Federal Reserve Board determines to be financial in nature or incidental to a financial activity.<sup>6</sup>

Additionally, in a large number of published interpretations, the OCC has adopted expansive interpretations of the incidental powers authority of national banks under federal law<sup>7</sup> to allow national banks and their subsidiaries to be aggressive in developing new products and services and new ways to serve as financial intermediaries for customers and other counterparties.

Essentially, then, in the current competition for bank charters, the wild card statute is a way to make being chartered by New York State a more attractive option. Although the new statute does not, and could not, address the issue of preemption of the application of other states’ laws to out-of-state branches and activities, it is intended to keep the New York charter on an equal footing with the national charter in terms of bank powers and permissible activities. It allows a New York-chartered bank, upon receipt of the required Banking Board approval, to establish a financial subsidiary to engage in those activities currently permitted under the GLB Act for financial subsidiaries of national banks or such additional activities that may be permissible in the future.<sup>8</sup> The wild card statute also provides a streamlined procedure for a New York-chartered bank to obtain Banking Board authorization to conduct other activities that may be authorized for national banks over time, whether by OCC interpretation or otherwise.

## PROVISIONS OF THE WILD CARD STATUTE

The statute expressly links the powers of a New York banking institution to those of its counterpart federal institution — e.g., it provides that a New York-chartered bank may exercise any federally permitted power of a national bank, and that a New York-licensed branch or agency of a foreign bank may exercise any federally permitted power of a federally licensed branch or agency. The statute provides that a federally permitted power authorized for a New York banking institution under the wild card authority may not exceed, and must be limited by, any conditions, qualifications or restrictions on the power when exercised by the counterpart federal institution, unless otherwise authorized under other New York State law, rule, regulation, policy, or judicial decision. It further provides that the New York State Superintendent of Banks may impose by order any other terms and conditions as he or she finds necessary and proper including, but not limited to, a requirement that any federally permitted power be exercised, conducted or held in a subsidiary rather than directly in the bank itself.<sup>9</sup>

Where a New York-chartered bank is permitted under the wild card statute to engage in the business of insurance, the bank must conduct such business subject to regulation by the New York State Department of Insurance and in compliance with all applicable insurance laws, rules, and regulations. However, the Superintendent, in consultation with the New York State Superintendent of Insurance, may exempt New York-chartered banks from any insurance law, rule or regulation that has been preempted for national banks under federal law. Additionally, in those instances where a federally permitted power authorized under the wild card statute is subject to regulation by a government agency other than the New York State Banking Department, the Banking Board or the New York State Insurance Department, a New York-chartered bank exercising that power must do so in compliance with such other regulatory scheme.<sup>10</sup> The statute also imposes a number of substantive requirements and restrictions on the conduct of insurance activities by New York-chartered and federally chartered banking institutions.

The new wild card authorization will expire on September 10, 2009, although the statute provides for the Superintendent to report to the New York State Legislature and the Governor on its impact on preserving the state

charters in New York. This suggests that the Legislature may be expected to renew the statute if it can be shown to have had a positive effect. We believe the benefit of the statute is self-evident and thus it should have been made permanent in the first place. Any federally permitted powers approved under the wild card statute would survive the repeal of the statute itself.<sup>11</sup>

## PROCEDURE FOR OBTAINING A WILD CARD POWER

Generally, in order to obtain a wild card power under the new statute, the bank makes an application to the Superintendent.<sup>12</sup> The application should be a relatively simple procedure. It can be in letter form and should contain the following information:

1. the name of the institution;
2. the name, position, address, telephone number, fax number and e-mail address for the individual(s) designated as the main contact person(s) for the purposes of the application;
3. the legal entity in which the activity will be conducted;
4. the location where the activity will be conducted (address, telephone number, fax number, e-mail address, Web site address);
5. the officer(s) responsible for said activities;
6. a detailed description of the particular federal power the applicant wishes to exercise;
7. a copy of the business plan for such activity;
8. a statement of whether this activity/product has been reviewed by the applicant's new product/activity committee and, if so, a copy of this committee's report should be included with the application;<sup>13</sup>
9. a copy of the applicant's new product/activity approval policies and procedures;
10. a detailed description of the source or sources of legal authority indicating that such power has been federally permitted for the applicant's type of institution; and

11. a detailed description of any conditions, qualifications or restrictions imposed by federal laws or regulations, or otherwise by federal regulatory agencies, on the exercise of the power, and supporting documentation as to how the applicant would comply with them.

Upon receipt of the application, notice would be posted in the New York State Banking Department *Weekly Bulletin*.<sup>14</sup>

If the Superintendent determines not to recommend approval of the application, the Superintendent will notify the applicant in writing that it may not exercise the requested power. If the Superintendent recommends approval of the application, and the Banking Board approves it, the applicant may exercise the federally permitted power subject to such terms and conditions as the Banking Board may have approved.<sup>15</sup>

In order to approve an application, the Banking Board must determine that the Superintendent's recommendation is (i) consistent with the policy of the State of New York, as declared in Section 10 of the New York Banking Law, that the business of banking organizations be supervised and regulated to ensure the safe and sound conduct of such business and, among other things, to protect the public interest and the interests of depositors, creditors and stockholders, and (ii) necessary to achieve or maintain parity between state-chartered banking institutions and their counterpart federal-charter banking institutions.<sup>16</sup>

In addition, the Banking Board, upon the recommendation of the Superintendent, may make the approval applicable to one or more additional state-chartered banking institutions of the same type.<sup>17</sup>

## BEYOND THE WILD CARD STATUTE

Being a state-chartered bank potentially holds an advantage over the national bank charter. Section 24 of the Federal Deposit Insurance Act, which generally limits the activities and equity investments of insured state banks to those permissible for national banks, provides that a state-chartered bank can engage in activities beyond those permissible for national banks if the bank receives prior approval from the FDIC and the state-chartered bank meets applicable capital adequacy requirements.<sup>18</sup> The FDIC seems to have

been rather cautious in granting such approvals, and will not allow any overly risky activities. Nevertheless, since the statute was enacted in 1991, a large number of exceptions have been granted to state-chartered banks,<sup>19</sup> primarily relating to the holding and development of interests in real estate.

If New York is serious about reviving the dual banking system and making New York an attractive place for a bank to be chartered, the newly created New York State Commission to Modernize Financial Services<sup>20</sup> and the banking committees in the state Senate and Assembly should work to draft and pass legislation that would authorize New York banks to engage in activities beyond those allowed by nationally chartered banks. Such legislation should, like the wild card statute, provide an expedited procedure for seeking approval from state regulators and full support for seeking the necessary approvals from the FDIC. If the bank is a state member bank, it might also have to seek permission from the Federal Reserve Board, if the new lines of business are regarded as a change in the general character of the bank's business.<sup>21</sup>

We recognize that, in the current environment, this may seem like whistling in the wind. But hopefully there are many low-risk, fee-income-generating financial activities not now provided by banks, and, in any event, the FDIC will serve as a governor of risk-taking.

## NOTES

<sup>1</sup> The statute is codified at Article 2, Section 12-a of the New York Banking Law.

<sup>2</sup> The references in this article to New York-chartered banks generally also include New York-licensed branches and agencies of foreign banks, although the different forms of corporate organization of those types of institutions may lead to some differences in how the wild card authority will be applied in particular cases.

<sup>3</sup> This position was very recently affirmed by the Second Circuit in *Clearing House Association, L.L.C. v. Cuomo*, \_\_\_ F.3d \_\_\_, 2007 WL 4233358 (2nd Cir. 2007). In this case the OCC and the Clearing House Association sought and received a declaratory injunction barring the New York Attorney General from infringing on the OCC's exclusive authority over national banks and their subsidiaries and barring investigations or enforcement actions by the state concerning national banks and their subsidiaries for possible discriminatory practices relating to residential mortgages.

<sup>4</sup> New York Superintendent of Banks Richard H. Neiman stated in a recent press

release: “Federal preemption of state laws over the past few years has limited state authority to address some critical issues and in some cases limited state laws designed to protect New Yorkers.” *See also*, Visitorial Powers Final Rule Questions and Answers, January 7, 2004, located on the OCC Web site at <http://www.occ.treas.gov/Consumer/2004-3eVisitorialruleQNAs.pdf>.

<sup>5</sup> The GLB Act also expanded the securities underwriting and dealing authority of national banks themselves by authorizing well-capitalized national banks to underwrite and deal directly in municipal revenue bonds. 12 U.S.C. § 24(Seventh).

<sup>6</sup> *See* 12 U.S.C. § 24a; 12 C.F.R. § 5.39.

<sup>7</sup> 12 U.S.C. § 24(Seventh).

<sup>8</sup> Specifically, the wild card statute defines the term “federally permitted power,” which it authorizes New York banking institutions to exercise (subject to the requirements and procedure discussed below), to mean “any right, power, privilege or benefit, any activity, or any loan, investment or transaction which a federally chartered banking institution *directly or through a subsidiary or subsidiaries*, may lawfully exercise or into which it may lawfully engage or enter.” (emphasis added).

<sup>9</sup> Section 12-a(6).

<sup>10</sup> Section 12-a(7).

<sup>11</sup> Similarly, regulations that were adopted under the predecessor wild card statute in New York, which has been repealed, such as that authorizing New York-chartered banks to underwrite and deal in the types of securities which may be underwritten and dealt in by national banks, are to remain in full force and effect notwithstanding the enactment of the new statute, unless the Banking Board specifically provides otherwise.

<sup>12</sup> Wild card powers can also be granted to a bank by the Superintendent without an application, in his or her sole discretion. Superintendent Neiman has indicated that he intends to exercise this power. In a recent press release he stated, “[w]e are actively looking at a number of potential Wild Card proposals that I will personally bring the Banking Board for resolution. I encourage the institutions we regulate to review their options under this law and submit applications for consideration.”

<sup>13</sup> Alternatively, the applicant can provide a description of the due diligence performed as it relates to the existence of supporting control, risk management, and financial environment.

<sup>14</sup> Section 12-a (3).

<sup>15</sup> Section 12-a (3).

<sup>16</sup> Section 12-a (3).

<sup>17</sup> Section 12-a (4).

<sup>18</sup> 12 U.S.C. §1831a(a). When this section was added, as part of the Federal Deposit Insurance Corporation Improvement Act of 1991, it was intended to impose and

clarify limitations on the activities of insured state banks acting as principal. The way the statute was worded, however, it also clarified how to obtain an exemption from the new limitation.

<sup>19</sup> A list and brief descriptions of each of the exemptions granted can be found on the FDIC's Web site at [www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html](http://www.fdic.gov/regulations/laws/bankdecisions/InvestActivity/index.html).

<sup>20</sup> This commission was created by Governor Spitzer on May 29, 2007, for the purpose of identifying ways for New York to retain and enhance its status as a world financial capital.

<sup>21</sup> See Federal Reserve Board Regulation H, 12 C.F.R. § 208.3(d)(2).

# DEFENDING CLAIMS OF FRAUDULENT TRANSFERS AGAINST LENDERS

STEVEN A. BECKELMAN AND DANIEL P. D'ALESSANDRO

*Creditors of defaulting borrowers and guarantors have asserted claims that the receipt of payment or additional security by institutional lenders constitutes a fraudulent transfer. This article discusses arguments for obtaining dismissal of fraudulent transfer claims in those circumstances.*

## WHAT IS A FRAUDULENT TRANSFER?

Under the Uniform Fraudulent Transfer Act (“UFTA”), a transfer is every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or parting with an asset or an interest in an asset, including the creation of a lien or other encumbrance.<sup>1</sup> A transfer is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer, and (a) the debtor transferred property “with [the] intent to defraud, delay, or hinder the creditor,” or (b) the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.<sup>2</sup> In deter-

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mining whether a transfer is fraudulent, courts consider “whether the debtor has put some asset beyond the reach of creditors which would have been available to them at some point in time ‘but for the conveyance.’”<sup>3</sup> In short, the UFTA is designed to prevent a debtor from depriving creditors by removing the debtor’s property from the “jaws of execution.”<sup>4</sup>

## A PREFERENCE IS NOT A FRAUDULENT TRANSFER

Initially, it is important to distinguish a preference from a fraudulent transfer. A payment by an insolvent satisfying the debt owed to one creditor rather than another creditor (i.e. a preference), does not constitute a fraudulent transfer.<sup>5</sup> Typically, preferences are vulnerable to avoidance only in proceedings under the federal bankruptcy code or state laws on assignments for the benefit of creditors or receiverships.<sup>6</sup> Otherwise, a preference will not be subject to UFTA as a fraudulent transfer. As explained by the New Jersey Supreme Court in *Smith v. Whitman*: “True a creditor who collects from an insolvent debtor fares better than other claimants. Yet if the transfer were set aside in favor of another creditor, there would be but a substitution of one preference for another.”<sup>7</sup>

## THE GOOD FAITH AND VALUE DEFENSE

The UFTA provides that a transfer to a good faith transferee for value is not voidable, and therefore, a good faith transferee retains a lien and the right to enforce an obligation to the extent of value given the debtor.<sup>8</sup> Good faith is considered to be lacking only where “the transferee knowingly aids the debtor in the debtor’s purpose to secrete assets for the debtor’s enjoyment, ...or joins in a plan designed solely to hinder creditors even though the transfer may be said to be supported by a sufficient consideration.”<sup>9</sup> A transferee, however, does not lack good faith simply because he “knew his debtor’s purpose to prefer or because he actively sought the preference.”<sup>10</sup>

## REPAYMENT OF ANTECEDENT DEBT IS NOT A FRAUDULENT TRANSFER

Where a lender deals with a borrower at arm's length and receives fair value, in the form of payment or a security interest, for any loan extended to the borrower, securing or satisfaction of an antecedent debt will not constitute a fraudulent transfer under UFTA, as an act to "hinder, delay or defraud any [other] creditor of the debtor."<sup>11</sup> The Official Comment of the Commissioners on Uniform State Laws to Section 4 of UFTA expressly contemplates the grant of a security interest and satisfaction of a debt secured by an asset of the debtor that exceeds the value of the debt itself:

The premise of [UFTA] is that when a transfer is for security only, the equity or value that exceeds the amount of the debt secured remains available to unsecured creditors and thus cannot be regarded as the subject of a fraudulent transfer merely because of the encumbrance resulting from an otherwise valid security transfer.

Such transfers are considered to be for reasonably equivalent value because what the debtor transferred is not the entire value of the property subject to the security interest but only a security interest to the extent of the debt itself, with the balance remaining available to other creditors.<sup>12</sup>

Consequently, in most circumstances, for a payment of an antecedent debt or grant of a security interest to fall within the prohibitions of UFTA, a competing creditor must show that the transfer was made to an "insider." A lender, however, does not obtain "insider" status through mere knowledge that the debtor has other existing creditors:

It is well settled that it is the right of the debtor who is in failing circumstances or insolvent to prefer one of his creditors; and it is equally the right of the creditor, acting honestly and in good faith, to obtain security for the debt from his debtor, or to extinguish the debt by purchasing property of the debtor which is of the same value as the credit surrendered.

And it is not sufficient, where the conveyance is supported by adequate consideration, that the debtor disposed of his property with intent to hinder, delay, and defraud his creditors. Satisfactory proof of the participation by the grantee or transferee in such fraudulent intent is a necessary ingredient. There must be a joint covinous agreement to hinder, delay, or defraud the grantor's creditors by the conveyance or transfer.<sup>[13]</sup>

Therefore, as where a lender receives a security interest in an asset of a debtor that exceeds the value of the debt itself, a transaction is not lacking good faith, or seen as an act to hinder, delay or defraud, where the lender is aware that the borrower has other creditors.

## DUTY OF LENDERS TO INSPECT FOR FRAUDULENT TRANSFERS

A lender does not run afoul of UFTA simply because it knows that the borrower has other creditors, or because the security interest obtained in exchange for the loan is on property that exceeds the value of the debt. The issue, however, arises as to whether a lender has an affirmative duty, prior to extending credit or loaning money and securing such with an asset of the debtor, to determine whether the potential borrower has participated in fraudulent transfers affecting the property subjected to the security interest. In most cases, the answer will be no, so long as the lender has neither actual nor constructive notice of a possible fraudulent transfer (i.e. is a good faith lender for reasonably equivalent value). A lender can typically protect itself as a good faith lender where nothing on the face of the documents contained in the loan application or the title report alert either the title company or the lender to the possibility of fraud or the need for additional investigation.<sup>14</sup> Where there is no indicia of fraudulent activity on the face of the documents, “[t]o hold [the lienholder] to have had notice of their grantor’s fraudulent intent would require a title attorney to search well beyond the records and enter the realm of speculation.”<sup>15</sup> A deed for nominal consideration in the chain of title is not constructive notice.<sup>16</sup>

## CONCLUSION

Under most circumstances, competing creditors bear a heavy burden when attempting to reach the deep pockets of a lender on fraudulent transfer grounds. So long as the transaction between lender and borrower is legitimate (i.e. in good faith and for fair value), a lender will likely not be liable for a fraudulent transfer when obtaining a security interest in a borrower's property in exchange for a loan, regardless of whether he knew of the existence of other creditors, the security interest he obtains exceeds the value of the debt, or the debt was subsequently satisfied at the expense and exclusion of other creditors.

## NOTES

- <sup>1</sup> Unif. Fraud. Trans. Act. § 1(12) (1984).
- <sup>2</sup> See Unif. Fraud. Trans. Act § 4 (1984).
- <sup>3</sup> *Gilchinsky v. National Westminster Bank N.J.*, 159 N.J. 463, 475 (1999) (quoting *In re Wolensky's Ltd. Partnership*, 163 B.R. 615, 626-27 (Bankr. D.C. 1993); *Grand Lab., Inc. v. Midcon Labs of Iowa*, 32 F.3d 1277, 1282 (8th Cir. 1994)).
- <sup>4</sup> See *id.* at 475 (quoting *Klein v. Rossi*, 251 F. Supp. 1, 2 (E.D.N.Y. 1966)).
- <sup>5</sup> See *Smith v. Whitman*, 39 N.J. 397, 402 (1963).
- <sup>6</sup> See *id.* at 403.
- <sup>7</sup> *Ibid.*
- <sup>8</sup> See, e.g., *Barsotti v. Merced*, 346 N.J. Super. 504, 516 (App. Div. 2002) (positing that because there was no proof that home transferred without receiving fair value in exchange, and because there was no indication that the transfer was not otherwise an arm's-length transaction, it could not be said that the transfer was not to a good faith transferee for reasonably equivalent value).
- <sup>9</sup> *Smith, supra*, 39 N.J. at 403.
- <sup>10</sup> *Id.* at 405.
- <sup>11</sup> *B.E.L.T., Inc. v. Wachovia Corp.*, 403 F.3d 474 (7th Cir. 2005); *In re Liquidation of Medicare HMO, Inc.*, 689 N.E.2d 374 (Ill. App. 1997)
- <sup>12</sup> See *Barsotti, supra*, 346 N.J. Super. at 516; see also *First National Bank of Seminole v. Hooper*, 104 S.W.3d 83 (Tx. 2003) (finding that, despite the borrower's intending to defraud the judgment creditor, the transfer to be for reasonably equivalent value because the debtor did not transfer the entire value of the property subject to the security interest but only a security interest to the extent of the debt, with the bal-

ance remaining available to other creditors); *Yokogawa Corp. of America v. Skye Int'l Holdings, Inc.*, S.W.3d 266 (Tx. App. 2005) (stating that even knowledge of financial condition of grantor of security interest does not constitute bad faith).

<sup>13</sup> *Hersh v. Levinson Bros.*, 117 N.J. Eq. 131 (E. & A. 1934).

<sup>14</sup> See *Hall v. World Savings and Loan Association*, 943 P.2d 855, 861 (Ariz. App. Div. 1 1997) (finding bank to be good faith lender for value where nothing in record put bank on notice of a fraudulent transfer in an action where husband conveyed his interest in residence to his wife after judgment was obtained against him in another jurisdiction, and wife subsequently obtained loan from bank in exchange for a deed of trust); see also *Chrysler Credit Corp. v. Burton*, 599 F. Supp. 1313, 1317-19 (M.D.N.C. 1984) (holding that although debtor's conveyance of two tracts of real estate to his fiancé just prior to consent judgment against him was fraudulent, the bank which held a deed of trust from debtor and his wife to secure a loan was a bona fide purchaser for value because the certificate of title did not reveal any prior judgments or liens in the chain of title; and therefore, deed of trust was valid and protected from avoidance under fraudulent conveyance law; *Persons v. Bergmann*, 182 N.J. Super. 476 (App. Div. 1982) (finding that third party complaint failed to state a claim against purchasers for value without notice of fraudulent transfer in chain of title).

<sup>15</sup> *Chrysler Credit Corp.*, *supra*, 599 F. Supp. at 1318-19.

<sup>16</sup> See *id.* at 1318; *Hall*, *supra*, 189 P.2d at 861.

# COMPLIANCE WITH THE NEW IDENTITY THEFT PREVENTION REGULATIONS

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*The proliferation of e-commerce and the simplification of Web site-creation technology has facilitated the escalation of identity theft, a crime that now affects millions of Americans and saps billions of dollars from U.S. businesses annually. Identity theft can affect a business's hard-won reputation and result in expensive litigation. New laws that go into effect on November 1, 2008, require banks and all other institutions that offer credit to protect themselves and their customers from identity theft in categorical ways. To comply with these regulations and avoid penalties resulting from audits by regulators, affected institutions must enact policies and procedures that identify red flags as described by the laws, detect them, and respond to them appropriately. Failure to comply with the new regulations on time can result in adverse regulatory actions.*

The President's Task Force on Identity Theft, established by executive order on May 10, 2006, uses the Federal Trade Commission's definition of identity theft: "a fraud attempted or committed using identifying information of another person without authority."<sup>1</sup> The fraud now known as identity theft is not a new crime, but as financial transactions shifted toward electronic- and online-based technology, its capacity to wreak havoc has grown exponentially. The Federal Trade Commission ("FTC")

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estimates that 9 million Americans have their identities stolen every year. A 2003 FTC survey estimated personal and business losses to identity theft at \$48 billion in the previous year.<sup>2</sup> That total has grown steadily ever since.

## MECHANICS OF IDENTITY THEFT

As consumers and businesses have become more aware of the dangers of identity theft, thieves have become more sophisticated. Personal information and free credit card offers are still stolen from mailboxes. Scams that encourage unsuspecting job applicants to surrender their personal data in response to fake job offers also remain popular, as does the time-honored tradition of eavesdropping, or “shoulder-surfing.” Dumpster divers can be foiled by paper shredders (although dogged criminals have been known to tape shredded documents back together). Online tactics, however, are now the preferred method for stealing data.

*Phishing* refers to attempts to persuade unsuspecting consumers to give up sensitive information, such as passwords or credit card numbers, by masquerading as a trustworthy entity, usually an online auction site, via a legitimate email complete with logos and working links to a Web site. The recipient is then threatened with the suspension or termination of his or her account for lack of compliance and is subsequently duped into “updating” a password or Social Security number. Armed with this information, thieves are able to steal money, credit, and even the account holder’s identity.<sup>3</sup>

*Pharming* can result in a data security breach if a customer provides information related to his or her account to someone claiming to represent the financial institution or creditor via a fraudulent Web site, which is usually created to look exactly like that of the actual institution. Attackers generally access the giant databases that route Internet traffic. Real-time modifications divert users to the criminal sites before they access the intended ones.<sup>4</sup> Thieves choose large sites, ensuring that monitors of the legitimate servers never notice as the traffic diverted to the fake sites represent only a fraction of the typical volume.<sup>5</sup>

The simplification of Web site–building technology has put such scams within reach of more and more people. In 2004, for example, a German teenager hijacked the domain name eBay.com.de “just for fun.” That time

the domain was returned without the commission of fraud.<sup>6</sup> Other instances have not ended as well and criminals always seem to stay one step ahead of software designed to foil phishing and pharming. Therefore, all companies that handle financial transactions over the Internet are at risk.<sup>7</sup>

The purposeful misdirection of personal mail is also often key to identity theft. Subsequently, would-be thieves also concentrate their efforts on the submission of fraudulent change-of-address requests to institutions that mail financial statements (or similar records containing sensitive information) to their customers. If successful, an identity thief can gather enough information to create chaos. For example, with only a bank statement, which contains an account number, information about total funds available, check numbers, and the bank's name (from which a routing number can easily be determined), a savvy criminal can wipe out the balance with new checks, printed with the old account number and a new, fake address. Misdirecting bank and credit card statements can also keep consumers from learning that their identities have been stolen until it is too late. For these reasons, managing and verifying change-of-address requests is a major part of the government's new anti-identity-theft Red Flag regulations.

## NEW REGULATIONS

In response to an increase in identity theft, President George W. Bush signed the Fair and Accurate Credit Transaction Act ("FACT") into law on December 4, 2003. FACT added several new provisions to the Fair Credit Reporting Act of 1970, including enhancing the weapons consumers have in their arsenal for combating identity theft.

On October 31, 2007, the Federal Reserve, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision, together with the U.S. Department of the Treasury and the Federal Trade Commission, took the next step and published a final set of Red Flag regulations that put certain sections of FACT into effect.<sup>8</sup> These regulations require all financial institutions and creditors to develop and implement written red flag identity theft programs no later than November 1, 2008. They also require credit and debit card issuers to establish policies

to assess the validity of all change of address requests.

The Red Flag rules are mandatory for all financial institutions, including banks, thrifts, mortgage lenders, and credit unions; casinos; U.S. branches, agencies, and commercial lending companies of foreign banks; and any other person or business arranging for the extension, renewal, or continuation of credit, including retailers, automobile dealers, utility companies, and telecommunications companies.

## COVERED ACCOUNTS

The final rules differentiate between an *account*, an ongoing relationship between a person and a financial institution or creditor, including an extension of credit and a deposit account, and a *covered account*, an account primarily for personal, family, or household purposes that involves or is designed to permit multiple payments or transactions. Covered accounts also include any other account for which there is a reasonably foreseeable risk of identity theft, either to customers, the financial institution, or the creditor.

Financial institutions and creditors must periodically determine whether they offer or maintain covered accounts. Those that do must develop and implement written identity theft prevention programs to detect, prevent, and mitigate identity theft in connection with such accounts. These programs must be appropriate to the size and complexity of the institution and the nature and scope of its activities; they must also address the changing nature of identity theft risks. The development of these programs is not, therefore, a one-time event: it is a dynamic, ongoing process.

## POLICIES AND PROCEDURES

An identity theft program must be risk based. Relevant red flags for covered accounts should be identified and incorporated into it. The program must then be able to detect any red flags that occur, respond to them appropriately, and ensure that the red flags themselves are updated periodically to reflect changes in identity theft risks to customers, the financial institution or creditor, and any service providers or vendors with which the institution

does business.

Written policies and procedures must be approved by the board of directors or an appropriate committee thereof. For a branch or agency of a foreign bank, the managing official in charge must give his or her approval; at a creditor without a board they must be approved by a management employee at the level of senior vice president or above. Lower-level employees may not oversee these programs.

The procedures must assign specific responsibilities for the program's implementation, for the approval of any material changes to the program, for the oversight of any arrangements with any services providers affected by the procedures, and for periodic reporting on (and the review of the reporting on) compliance with these regulations. These reports should evaluate how effectively the policies and procedures address the risk of identity theft with respect to both existing covered accounts and the opening of new ones. They should also cover any significant incidents involving identity theft, and management's response to them since the previous report, as well as any recommendations for material changes to the program.

Covered entities do not, however, have to create duplicate policies and procedures; existing procedures, controls, and processes can be used to address these requirements. For example, existing fraud prevention mechanisms might be leveraged to address these requirements.

Some questions to consider include: Do multiple business lines require a customized, enterprise-wide solution? Should customers be able to access their information only in person? What kind of accounts should customers be able to open online? The risk assessment conducted to assist in this determination should consider the following factors:

- Whether the regulations cover the accounts offered and maintained;
- The institution's size, location, and customer base;
- The methods it uses to open and access its accounts;
- The institution's previous experience with identity theft; and
- The cost and operational burden posed by countering any risk from identity theft.

## Red Flags

Red flags are a pattern of specific activity that indicates the possible existence of identity theft. An entity can detect red flags by obtaining and verifying identifying information about a person opening a covered account by using the procedures regarding identification and verification set forth in the Customer Identification Program rules of the U.S. PATRIOT Act. These include policies for authenticating customers, monitoring transactions, and verifying the validity of change of address requests. (No specific technology, system, process, or methodology, however, is required.)

In identifying relevant red flags for covered accounts, an institution must consider the types of accounts it offers or maintains and how it opens and provides access to these accounts. Any previous experiences with or incidents of identity theft should be considered as potential red flags, as should methods of identity theft the financial institution or creditor has identified that reflect changes in risk level. Red flags for online transactions are likely to be different from those for face-to-face transactions.

## Address Verification

The Red Flag rules' requirements for address verification, including e-mail addresses, are complex and are geared toward ensuring that institutions develop and implement policies and procedures making them reasonably confident that reports or statements they mail out or credit cards they issue actually belong to the consumers to whom they are sent. The rules also contain guidance for how to handle notices of address discrepancy sent by consumer reporting agencies. Existing customer identification procedures may be leveraged to meet the requirements of the new Red Flag regulations.

## Updates

Program updates should reflect changes in risks to customers or to the financial institution's or creditor's security regarding identity theft. Such updates should consider any experiences the institution has had with identity theft since the program was last updated, changes in the types of accounts

the entity offers, as well as any recent mergers, acquisitions, alliances, joint ventures, or service provider arrangements. Methods of identity theft change continually, as do the technologies used to identify, mitigate, and prevent it; these developments must also be examined in relation to any risk assessment program.

## Training

The procedures must include a training plan for the program's effective implementation. All existing employees must be trained in the aspects of the identity theft program in which they are expected to take part; the training must also be made part of any orientation program for new employees. Employees must be trained in any changes to the identity theft program in real time. In addition, the training program must include a mechanism to assess whether the training itself is relevant to the business and being delivered efficaciously.

## Audits

The Red Flag rules require the establishment of control and audit guidelines in order to ensure that the program is implemented adequately and tested independently. Because audit frequency is based on risk, it will, at least initially, likely be more frequent in the program's initial stages.

## RESPONDING TO IDENTITY THEFT

Once a red flag has been detected, the account involved should be monitored for evidence of identity theft. After the institution has made a determination of identity theft, it might take one or more of the following actions:

- Contact the customer;
- Change any passwords or security codes to the account;
- Temporarily freeze or close the account;

- Reopen the account with a new account number;
- Decline to open a new account; and
- Notify law enforcement and file a security assessment report.

The institution may also decide not to attempt to collect on the account or sell the account to a debt collector. Each triggering event is unique and must be reviewed individually. In some cases, a response may not be warranted if the impetus behind it is determined to be false.

## BUSINESS MODEL CONSIDERATIONS

The incorporation of the policies and procedures required by the new Red Flag rules is likely to raise questions related to an institution's business model. Among the most pertinent are whether compliance will require an expansion in staffing and whether any compliance costs can — or should — be passed on to consumers. While these regulations will protect financial institutions and creditors from the massive costs of fraud, identity theft is a crime aimed at consumers, and the regulations were passed by Congress and signed into law with the public in mind. Should their introduction be made known to consumers, and in what way should consumers' expectations about them be managed? More importantly, will consumer groups feel that the regulations respond adequately to the threat?

## CONCLUSION

Different organizations are tackling compliance with these regulations differently. Some are handling it through their fraud prevention departments; others, in their banking secrecy act departments; some in their credit risk areas; still others, in their consumer compliance departments.

A first step toward compliance might be to form a task force of all internal stakeholders and identify key senior members of management responsible for the timely development, implementation, and ongoing administration of the red flag identity theft program. The task force should review existing fraud prevention and customer identification policies and procedures to determine whether any can be leveraged to fulfill these new obliga-

tions. It should also assess whether the organization has the necessary resources in house to develop and document the program, or whether outside resources will be needed.

Any outside resources engaged should be able to develop a risk assessment methodology, define and develop the red flag identity theft program, conduct a review of a red flag program developed in house, author a training program and provide initial and ongoing employee training, and investigate and respond rapidly to any incidents of identity theft.

Banking regulators are already inquiring about the status of Red Flag regulation compliance programs. With only months to go, financial institutions, and creditors should take immediate measures to formulate their action plans in order to comply with the November 1 deadline.

## NOTES

<sup>1</sup> Federal Trade Commission, "Agencies Issue Final Rules on Identity Theft Red Flags and Notices of Address Discrepancy," October 31, 2007. <http://www.ftc.gov/opa/2007/10/redflag.shtm>.

<sup>2</sup> Federal Trade Commission, *Identity Theft Survey Report* (prepared by Synovate), McLean, VA: 2003).

<sup>3</sup> Polly Samuels McLean and Michelle M. Young, "Phishing and Pharming and Trojans — Oh My!" *Utah Bar Journal*, April 2006. [http://webster.utahbar.org/bar-journal/2006/04/phishing\\_and\\_pharming\\_and\\_troj.html](http://webster.utahbar.org/bar-journal/2006/04/phishing_and_pharming_and_troj.html).

<sup>4</sup> Microsoft, "Pharming: Is Your Trusted Web Site a Clever Fake?" January 3, 2007. <http://www.microsoft.com/protect/yourself/phishing/pharming.msp>.

<sup>5</sup> Jane Larson, "New Crop of Thieves: Pharmers Hit Net Banking," *The Arizona Republic*, April 19, 2005. <http://www.azcentral.com/arizonarepublic/news/articles/0419pharming19.html#>.

<sup>6</sup> Martin Fiutak, "Teenager Admits eBay Domain Hijack," *C|net News.com*, September 8, 2004. [http://www.news.com/Teenager-admits-eBay-domain-hijack/2100-1029\\_3-5355785.html](http://www.news.com/Teenager-admits-eBay-domain-hijack/2100-1029_3-5355785.html).

<sup>7</sup> Federal Deposit Insurance Corporation, "*Pharming*": *Guidance on How Financial Institutions Can Protect Against Pharming Attacks*, Financial Institution Letter FIL-64-2005. Washington, DC: July 18, 2005.

<sup>8</sup> Board of Governors of the Federal Reserve System, et al., "Agencies Issue Final Rules on Identity Theft Red Flags and Notices of Address Discrepancy," October 31, 2007. <http://www.federalreserve.gov/newsevents/press/bcreg/20071031a.htm>.

# BASEL II AND ITS IMPACT ON THE PROPERTY MARKET IN THE HONG KONG SPECIAL ADMINISTRATIVE REGION

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*A new Basel Accord, the Basel II Accord was agreed by all the members of the Basel Committee on Banking Supervision, including the U.S.A., in 2004. Under the Basel II Accord, the capital adequacy ratio remains as a core component. However, the risk weights for classified risks have been changed. The risk weight for residential mortgages is lower than before, but the risk weighting for commercial real estate mortgages has become much stricter. These changes would unavoidably influence the lending preferences and lending capacity of banking institutions. This article studies the Basel II Accord in the Hong Kong context. Furthermore, expected impacts are discussed from both the macro and micro perspectives.*

The Basel Accord (“Basel I”) was developed by the Bank for International Settlements (“BIS”) as soft law for international banking governance in 1988.<sup>1</sup> It focused on capital adequacy requirements, and provided that banking institutions should maintain a minimum capital adequacy ratio. Basel I unified the definition of capital adequacy ratio (“CAR”), i.e., the ratio of capital to risk-weighted assets. However, the calculation method for the capital adequacy requirement remained under further development, and Basel I, as the first effort to converge capital requirements, applied the “simplest method,” i.e., simply dividing all the assets into five classifications and directly assigning risk weight to each classification. As the risks faced by banking institutions have been increasing steadily following an extension in the scope of financial activities, the

method provided by Basel I cannot satisfy the requirements for present day banking practices. Originally, Basel I only included the credit risk. In 1996, it extended to market risk, but other risks, including operational risk, interest rate risk etc. were not considered in Basel I. Moreover, assigning a certain risk weight to a class of assets arbitrarily was criticized as unreasonable.<sup>2</sup> Consequently, the Basel Committee on Banking Supervision (“the Committee”) decided to revise Basel I, and after a four-year consultation, the final revised capital accord (“Basel II”) was issued in 2004.<sup>3</sup>

As prominent financial intermediaries, banking institutions play an important role in all economies, and the development of any particular sector of the economy is closely related to its access to bank lending. As the calculation method for the capital adequacy ratio may change the preference of banking institutions, it may thus influence the availability of bank lending to certain sectors of the economy. As far as the property market is concerned, bank lending remains typically the main funding source, and lending preferences of banking institutions would thus affect the development of property markets directly.

This article first introduces Basel II and then analyzes the impact of Basel II on property markets. In view of the individual characteristics of property markets in different jurisdictions, this article focuses on the impact

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of Basel II in the context of the Hong Kong Special Administrative Region of China (“Hong Kong”).

## THE BASEL II ACCORD

The minimum capital requirement relies on the capital-to-asset ratio (“CAR”) as the principal metric. The assets are risk-weighted rather than a simple sum of all assets of a banking institution. CAR should be calculated by the following formula:<sup>4</sup>

$$\text{CAR} = \frac{\text{Capital}}{\text{Weighted risk Assets}}$$

Basel I mainly provides three factors in considering minimum capital requirements: (1) the minimum CAR (eight percent); (2) the definition of capital; and (3) the risk weights for every asset classification. As the successor of Basel I, Basel II retains two factors of Basel I, i.e., the minimum capital adequacy ratio and the definition of capital. Nevertheless, Basel II changes the calculation method for the capital adequacy ratio, and especially introduces a three pillar approach in order to align the minimum capital requirement of banks more closely to the risks they face.

The three pillars approach is the basic structure of Basel II. Pillar I is concerned with the minimum capital requirements, which are also provided by Basel I. However, Basel I only captures credit risk and market risk while Basel II covers one more risk: operational risk. Pillar II is a supervisory review process. It requires banking institutions and supervisors to have a sound supervisory process to review the measurements related to Pillar I. Further, some risks not captured by Pillar I considerations are also to be considered under Pillar II. These risks include credit concentration risk, interest risk in the banking book, and business and strategic risk. Pillar II is concerned with market discipline, which requires that banking institutions disclose information related to CAR.

Among the three pillars, Pillar I is critical in the sense that it has the potential to affect property markets directly. Certainly, not all risks under

the three Pillars would have the same impact on the property market, for example credit risk is relatively more important than the remaining two in CAR. The change of risk weights for property lending focuses attention on the change of the calculation method for credit risk. The calculation of credit risk will thus also be illustrated below.

In contrast with Basel I, there are two significant changes in the calculation of CAR for credit risk in Basel II, i.e., (1) diversification of calculation methods, and (2) introduction of the external credit rating. Basel II provides for the standardized approach and the Internal Rating-based approach (“IRB approach”). Not all the asset classifications under the two approaches are related to the property market. The parts highlighted in italics in Table 1 may affect the property market, and will be further discussed.

The standardized approach is an amendment of the previous calculation method provided by Basel I. The risk weights for every asset classification are provided by Basel II. Banking institutions should calculate the CAR according to the corresponding risk weights. As far as property lending is concerned, the claims secured by residential property shall be allocated a 35 percent risk weight,<sup>5</sup> while a 100 percent risk weight shall be applied to claims secured by commercial real estate.<sup>6</sup> The corporate loans are related to the loans without collateral for developers and for other enterprises, for which the risk weights vary from 20 percent to 150 percent according to different credit rating (20 percent, 50 percent, 100 percent, and 150 percent respectively correspond to the credit rating of AAA to AA-, A+ to A-, BBB+ to BB-, and below BB-. Unrated corporate loans shall be allocated 100 percent risk weight. (See Table 2).

The IRB approach for non-securitization risk includes a foundational IRB approach and an advanced IRB approach. Both of them rely on four parameters: the probability of default (“PD”), loss given default (“LGD”), the exposure at default (“EAD”) and the effective maturity (“M”).<sup>7</sup> The foundational IRB approach requires bank institutions to estimate PD, and to use supervisory estimates for the other three parameters. Under the advanced IRB approach, banks may provide their own estimates of PD, LGD, and EAD and must provide their own estimates of M.<sup>8</sup>

Property lending is mainly classified as corporate exposures<sup>9</sup> and retail exposures<sup>10</sup> under the IRB approach. Among the three sub-classes of retail

Table 1		
Approach	Classes of claims/exposures	Sub-classes
Standardized approach	Claims on sovereigns Claims on non-central government public sector entities Claims on multilateral development banks Claims on banks, securities firm <i>Claims on corporations</i> Claims included in the regulatory retail portfolio <i>Claims secured by residential property</i> <i>Claims secured by commercial real estate</i> past due loans higher risk categories other assets	
The Internal Ratings-Based approach	<i>Corporate exposures</i>	Project finance Object finance Commodities finance <i>Income-producing real estate</i> <i>High-volatility commercial real estate</i>
	Sovereign exposures	
	Bank exposures	
	<i>Retail exposures</i>	<i>Exposures secured by residential properties</i> Qualifying revolving retail exposures All other retail exposures
	Qualifying revolving retail exposures Equity exposures	
Source: Basel Committee on Banking Supervision (2005), <i>International Convergence of Capital Measurement and Capital Standards (A Revised Framework)</i> , Part 2, Section IIA and IIIB1.		

Table 2					
Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

Source: Basel Committee on Banking Supervision (2005), *International Convergence of Capital Measurement and Capital Standards (A Revised Framework)*, Part 2, Section IIA6.

exposures, i.e., exposures secured by residential, qualifying revolving retail exposures and all other exposures, only residential mortgages would affect the property market. Different from the residential mortgage under the standardized approach, the residential mortgage as the sub-class of retail exposure under the IRB approach refers to not only the lending fully secured by a residential mortgage, but also the lending partly secured by the same.<sup>11</sup> Basel II provides the formulas for retail exposures, but it should be noted that there is no difference between the foundational IRB and the advanced IRB approach for retail exposure. Banks must estimate PD, LGD, and EAD by themselves.<sup>12</sup>

The calculation for corporate exposures is complicated. Basel II provides that banks will be permitted to separately distinguish exposures to small- and medium-sized entity (“SME”)<sup>13</sup> borrowers from large entity borrowers. For SMEs, a firm-size adjustment (i.e.,  $0.04 \times (1 - (S - 5) / 45)$ )<sup>14</sup> is made to the corporate risk weight formula.<sup>15</sup> That is to say, under the same set of conditions, the risk weight for SMEs will be lower than that for large entities.

Furthermore, five sub-classes of specialized lending (“SL”)<sup>16</sup> are identified within corporate exposure, i.e., project finance, object finance, commodities finance, income-producing real estate and high-volatility commercial real estate. Among these sub-classes, income-producing real estate and high-volatility commercial real estate are related closely to property lending.

“Income-producing real estate (“IPRE”) refers to a method of pro-

viding funding to real estate (such as office buildings to let, retail space, multi-family residential buildings, industrial or warehouse space, and hotels) where the prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the asset. The primary source of these cash flows would generally be lease or rental payments or the sale of the asset. The borrower may be, but is not required to be, an SPE, an operating company focused on real estate construction or holdings, or an operating company with sources of revenue other than real estate. The distinguishing characteristic of IPRE versus other corporate exposures that are collateralized by real estate is the strong positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of default, with both depending primarily on the cash flows generated by a property.<sup>17</sup>

High-volatility commercial real estate (“HVCRE”) lending is the financing of commercial real estate that exhibits a higher loss rate volatility (i.e., higher asset correlation) compared to other types of SL. HVCRE includes:

- commercial real estate exposures secured by properties of types that are categorized by the national supervisor as sharing higher volatilities in portfolio default rates;
- loans financing any of the land acquisition, development and construction (“ADC”) phases for properties of those types in such jurisdictions; and
- loans financing ADC of any other properties where the source of repayment at origination of the exposure is either the future uncertain sale of the property or cash flows whose source of repayment is substantially uncertain (e.g., the property has not yet been leased to the occupancy rate prevailing in that geographic market for that type of commercial real estate), unless the borrower has substantial equity at risk.<sup>18</sup>

The calculation method for SL is similar to that for other corporate

exposures. The difference is that if banks do not meet the requirements for estimation of PD under the corporate foundational approach for their SL assets, they should apply the “supervisory slotting criteria approach” to SL assets.<sup>19</sup> That approach requires that banks should rate SL assets

Table 3 Supervisory Categories and UL Risk Weights for Other SL Exposures					
Supervisory categories	Strong	Good	Satisfactory	Weak	Default
Broadly corresponding to external assessments	BBB- or better	BB+ or BB	BB- or B+	B to C-	Not applicable
Risk weight	70%	90%	115%	250%	0%

Source: Basel Committee on Banking Supervision (2005), *International Convergence of Capital Measurement and Capital Standards (A Revised Framework)*, Part 2, Section IIC1(iii).

Table 4 Supervisory Categories and UL Risk Weights for High-volatility Commercial Real Estate				
Strong	Good	Satisfactory	Weak	Default
95%	120%	140%	250%	0%

Source: Basel Committee on Banking Supervision (2005), *International Convergence of Capital Measurement and Capital Standards (A Revised Framework)*, Part 2, Section IIC1(iii).

according to the slotting criteria provided by Basel II, and each supervisory category has the corresponding risk weight for unexpected losses (Table 3 and Table 4).

## THE IMPLEMENTATION OF BASEL II IN THE HONG KONG SAR

Hong Kong has always taken an active attitude to Basel II. In order to keep the status as an international financial center, Hong Kong decided to implement Basel II from January 1, 2007 onwards. The Hong Kong Monetary Authority (“the HKMA”), as the banking regulatory authority, is responsible for the aforesaid implementation. In August 2004, the HKMA issued *Proposals for the Implementation of the New Capital Adequacy Standards (“Basel II”) in Hong Kong*<sup>20</sup> which marks its commencement. In 2005, the Legislative Council amended the Banking Ordinance (“the BO”) in such a way that it provided for the HKMA to make rules prescribing the manner of calculating the Capital Adequacy Ratio of Authorized Institutions (“AIs”).<sup>21</sup> Accordingly, the HKMA issued the Banking (Capital) Rules (“Capital Rules”)<sup>22</sup> and the Banking (Disclosure) Rules (“Disclosure Rules”)<sup>23</sup> in October 2006.

Capital Rules are made with reference to Basel II. All the approaches of Basel II for credit risk are available for AIs. The calculations for each asset class are similar to Basel II. In particular, given the demand of small AIs,<sup>24</sup> Capital Rules specially provide the Basic approach, which is primarily intended for AIs with small, simple, and straightforward operations, thus addressing smaller AIs’ concerns over the complexity and costliness of implementing Basel II.<sup>25</sup> Furthermore, the Basic approach could also be used as the interim approach for those AIs intending to implement the IRB approach during the transitional period from 2007 to 2009.<sup>26</sup> The on-balance sheet exposures under the Basic approach are classified into sovereign exposures, public sector entity exposures, multilateral development bank exposures, bank exposures, cash items, residential mortgage loans, and other exposures.<sup>27</sup> The risk weights for every exposure do not depend on the external rating, but are provided by Capital Rules.

## THE IMPACT OF BASEL II ON THE PROPERTY MARKET

The impact of Basel II is derived mainly from the differences between Basel I and Basel II. Banking institutions are to keep more capital for loans with higher risk weights. Thus, if the risk weight for property lending increases, the loans for the property market may decrease or the interest rate charge by banking institutions may increase. When comparing Basel I and Basel II, it can be observed that the risk weights for some kinds of property lending, i.e., claims on the corporate with credit rating below BB-, may increase, but risk weights for others, i.e., residential mortgage, may decrease. In order to understand the influence of this phenomenon, the impact of Basel II on developers, individuals, property-holding shell companies, and the real estate cycle will be analyzed. The IRB approach relies on the estimation of four parameters. It is not easy to anticipate the change of risk weights, so the following discussion will mainly be done in pursuit of the standardized approach.

### PROPERTY DEVELOPERS

Generally developers are registered as corporations, and therefore the impact of Basel II on developers focuses on the change of risk weights for corporations. In Basel I, loans to corporations were allocated 100 percent.<sup>28</sup> As shown in Table 2, under Basel II, the Standardized approach provides that the risk weights for corporations vary from 20 percent to 150 percent according to the credit rating.<sup>29</sup> Banking institutions shall not apply one unified risk weight to all exposure to corporate, but determine the risk weight according to the credit rating of the corporate, which may widen the gap between big developers and small developers.

Suppose a banking institution lends 100M HK\$ to a developer. If the developer is rated AAA to AA-, banking institutions should keep \$1.6M HK\$ of capital in order to satisfy the capital adequacy requirement. However, if the developer is rated below BB-, banking institutions must maintain capital equal to 12M HK\$, which is more than seven times the capital in the first scenario.

With the same amount of capital, banking institutions may avoid the higher risk weight assets and be reluctant to lend to developers with low

credit ratings. As a matter of prudential practice, they would increase the interest rate for the developers with lower credit rating. Thus, under the provisions of Basel II, the developers with good credit rating may find it much easier to borrow from banking institutions than before, but the developers with lower credit rating would face the bad situation. Either the property lending may not be available easily, or the cost for property lending would increase. Both the current credit rating of some developers and the criteria of the credit rating system itself will determine the ease of obtaining a good credit rating for developers, especially for small developers.

The criteria adopted by credit rating agencies are strict and the credit rating agencies do, in turn, need the recognition from banking supervisors. In order to avoid risk, banking supervisors will not loosen the criteria and consequently it will be difficult for developers to obtain a good credit rating. Among the 276 credit ratings for corporations in Asia published by S&P, 36 were rated higher than A+, 79 were rated between A+ to A-, 123 were rated between BBB+ to BB-, and 38 were rated below BB-.<sup>30</sup> It should be noted that most corporations with higher credit rating are international corporations in Japan and Korea. Industry risk is one factor considered by S&P during the rating process. Property market is not an industry favored by S&P.<sup>31</sup> The previous credit ratings of several developers in Hong Kong have shown that it is not easy to be granted a higher credit rating. Hysan was ranked BBB by S&P and Baa1 by Moody's in 2006.<sup>32</sup> Sun Hung Kai was ranked A by S&P and A1 by Moody's in 2006.<sup>33</sup> Cheung Kong was ranked A- by S&P.<sup>34</sup> Swire was ranked A- by S&P and A3 by Moody's in 2005. Sino was ranked BB by S&P. The future of small and medium developers is even worse. Taking the S&P corporate rating criteria as an example, the size may be significantly correlated to rating because size often provides a measure of diversification, and/or affects competitive position.<sup>35</sup> Therefore, a small corporation is often not favored by the credit rating agency.

Obtaining external credit ratings is relatively expensive to the customer.<sup>36</sup> There has been no unified payment standard in the credit rating industry. Moody's, S&P, and Fitch would charge credit rating on a case by case basis. However, the limited information indicates that the fee for corporate rating charged by S&P would go up to 4.25 basis points for most transactions.<sup>37</sup> This fee may be paid by developers or banking institutions.

However, this fee would eventually be included as a borrowing cost. Thus, even for developers with high credit ratings, Basel II unavoidably increases the cost of lending from banking institutions. Basel II does not mention whether borrowers must provide a new credit rating once they decide to borrow from banking institutions again, but we can expect that a particular credit rating cannot be used for long. In other words, it is likely that the cost of obtaining a credit rating cannot be apportioned.

It could be suggested that most developers may prefer not to be rated by credit rating agencies because of two reasons. Firstly, Basel II provides that claims on unrated corporations would be allocated a 100 percent risk weight. If we ignore the cost of obtaining a credit rating, those corporations under Basel II should have the same treatment as under Basel I. Secondly, Basel II provides that claims on corporations with ratings below BB-, a 150 percent risk weight should be applied, which is even higher than for unrated corporations. Thus, given the cost of credit rating and the uncertainty of the result, developers may increasingly choose not to be rated. However, in the absence of a better choice, banking institutions would still push for the use of the external credit rating. It may be the trend to determine the risk weights by using the credit rating.

Accordingly, under the standardized approach, developers may have to be rated as the requirement of banking institutions. Higher credit rating would benefit the developers, but it is not easy to be granted considering the strict criteria of credit rating, especially for small developers. Lower credit rating would make banking institutions reluctant to lend to developers, or lead to the higher interest rate and thus the higher borrower cost.

Under the IRB approach, both the foundational IRB approach and the advanced IRB approach rely on the estimates of banking institutions. Certainly the concept of "one size for all" would not be applied any more. Developers in good financial condition would be given a lower risk weight. The difference in treatment among the developers cannot be avoided under Basel II. Meanwhile, the supervisory slotting criteria approach increases the risk weights for SL exposures with unsatisfactory credit ratings, especially risk weight with respect to high-volatility commercial real estate.

Under the standardized approach and the IRB approach, it would be expected that the gap of access to property lending between big developers

and small developers would be widened, thereby reducing the room for development of the latter group. This situation would be more serious in Hong Kong than in other jurisdictions since the development industry in Hong Kong is dominated by a few large developers.

In Hong Kong, Fitch Ratings, Moody's Investors Service, Standard & Poor's Ratings Services, and Rating and Investment Information, Inc. ("R&I") are recognized by the HKMA for adopting the Standardized Approach in the calculation of credit risk.<sup>38</sup> Since all these are global rating agencies, the impact of Basel II on developers is expected to become more apparent. Firstly, according to some researches, the credit ratings provided by the global rating agencies are more rigid than those provided by the national rating agencies.<sup>39</sup> Secondly, fees paid to the global rating agencies are also very high as a result of which international or big corporations are favored. Thirdly, global rating agencies might have a comparative advantage in rating larger/more international companies while national rating agencies might have a comparative advantage in rating smaller/less international companies.<sup>40</sup> The lack of local credit rating agencies or smaller credit rating agencies in Hong Kong may lead to a decrease in the number of developers with credit ratings, and the situation is expected to be worse for medium and small developers.

From the macro-perspective, the difference in treatment among developers could strengthen the current oligopolistic structure of the real estate development market during the implementation of Basel II. Additional equity finance for small and medium developers is not easily obtained.<sup>41</sup> In contrast to big developers, small and medium developers rely more heavily on debt finance, i.e., bank lending. However, the cost of property loans may increase with the implementation of Basel II in 2007 due to the commission of credit rating, and banking institutions may not presently wish to lend.

In the residential property market of Hong Kong, 70 percent of all new private housing was supplied by the seven developers (namely Cheung Kong, Sun Hung Kei, Henderson, Hang Lung, Sino, Swire, New World Development and Hong Kong Land) between 1991 and 1994, and 55 percent of it came from only four of the seven.<sup>42</sup> The oligopolistic situation is already serious, and with high land prices and limited channels for financing, the situation is expected to deteriorate further.

## PROPERTY-HOLDING SHELL COMPANIES

Property-holding shell companies refer to companies which do not engage in any business activity except for the sole purpose of buying, holding, and selling of residential properties.<sup>43</sup> The residential mortgage loans of property-holding shell companies shall be allocated a risk-weight of 35 percent if:

- (1) the loan is secured by a first legal charge on one or more than one residential property;
- (2) the residential property is the residence of the director or shareholders of the borrower or is the residence of a tenant, or a licensee, of the borrower;
- (3) the loan-to-value ratio of the loan does not exceed 70 percent at the time a commitment to extend the loans was made by the institution, or the relation to a residential mortgage loan purchased by the institution, at the time the loan was purchased;
- (4) the loan-to-value ratio of the loan does not exceed 100 percent at any time after the loan is drawn by the borrower or purchased by the institution, as the case may be; and
- (5) all of the borrowed-moneys obligations of the company arising under the loan are the subject of a personal guarantee which is entered into by one or more than one director or shareholder of the company and which fully and effectively covers those obligations, the institution is satisfied that the guarantor is able to discharge all the guarantor's obligations under the guarantee and the loan has been assessed by reference to substantially similar credit underwriting standards as would normally be applied by the institution to an individual.<sup>44</sup>

If property-holding companies as borrowers do not satisfy all the requirements mentioned above but (1) the maximum aggregate exposure of an authorized institution to a single obligor, or to a group of obligors considered by the institution as a group of obligors for risk management purposes, does not exceed \$10 million, and (2) the loan-to-value ratio of the

loan does not exceed 90 percent at the time a commitment to extend the loan was made by the institution, or in relation to a residential mortgage loan purchased by the institution, at the time the loan was purchased,<sup>45</sup> a risk-weight of 75 percent shall be allocated by the institution. This is similar to the regulatory retail exposure for small and medium enterprises. If a property-holding shell company does not satisfy the requirement with respect to the maximum aggregate exposure of the institution to a single obligor or other aforementioned requirements, the risk-weight of 100 percent shall be allocated to a residential mortgage loan.<sup>46</sup>

Prior to the implementation of the Capital Rules, a property-holding shell company was regarded as a general kind of company, which means a 100 percent risk weight should be given to it. Meanwhile there are three kinds of Capital Rules: 35 percent, 75 percent, and 100 percent. It seems that obtaining loans from banking institutions may have become easier or they may have been charged a lower mortgage rate than before because a lower risk weight increases the preference of banking institution for loans for property-holding shell company. This may encourage using property holding company for short-term speculation since it may be easier to avoid taxes and pay a smaller stamp duty by trading the shares of the property holding company than a physical asset.

## INDIVIDUALS

Basel II favors residential mortgages, which can be revealed from its treatment of residential mortgages. The application requirements for individuals' residential mortgage are the same as those for residential mortgage of property-holding shell companies, which will be introduced in the last section. In sum, for the Banking (Capital) Rules, the risk-weights are 35 percent, 75 percent, or 100 percent according to different conditions under the standardized approach. However, the 35 percent risk weight is common for residential mortgages, which is lower than 50 percent under Basel I. Thus, it will be easier to secure residential mortgages for individuals from banking institutions than before.

The Basic approach is special in Hong Kong and it applies to small banking institutions. Under this approach, residential mortgage loans shall

be allocated a risk-weight of 50 percent, which is the same as the previous regulation. However, the new regulation adds one new requirement, which is that the loan-to-value ratio of the loan does not exceed 90 percent at the time a commitment to extend the loan was made by the institution, or in relation to a residential mortgage loan purchased by the institution, at the time the loan was purchased.<sup>47</sup> Before the launch of the Capital Rules, the HKMA suggested (using moral suasion, not prescription) a loan-to-value ratio according to the circumstances of the property market. Usually, a 70 percent loan-to-value ratio was common.<sup>48</sup> Capital Rules, however, set a far looser loan-to-value ratio of 90 percent as the requirement.

Nevertheless, the decrease in the risk weight for residential mortgage is questioned, especially in Hong Kong.<sup>49</sup> Banking institutions in Hong Kong lend too much money to the property market, and credit risk concentration has remained an HKMA concern for at least the past fifteen years. In December 2006, property lending (including loans for building and construction, property development and investment, and for the purchase of other residential property) accounted for more than 45 percent of total loans, of which residential mortgages accounted for about 30 percent.<sup>50</sup> The implementation of Basel II may lead to a further increase of residential mortgages. Although the mortgage loans delinquency ratio in Hong Kong is far below two percent,<sup>51</sup> the concentration of loans would further expose the stability of the banking system at risk.

## IMPACT ON THE REAL ESTATE CYCLE

In the prior section, the impact at micro-level was analyzed. However, in itself, such an analysis is insufficient in the sense that the relative importance of the impact on the supply or demand-side of the property market cannot be identified, thus whether implementation of Basel II would cause property prices to increase or decrease still remains unclear. In fact, implementation may anyhow affect the real estate cycle in a manner that results in generating a higher level of high price instability.<sup>52</sup>

The relationship between the property market and banking sector is bidirectional. Declines in property prices could lead to an increase in the proportion of bad loans in banking institutions. The collapse of the prop-

erty market often brings about banking crises. This has been the case in many financial crises since the 1980s.<sup>53</sup> Meanwhile, the increase/decrease in the volume of lending from banking institutions often, but not necessarily, coincides with a boom/bust in the property market. Research shows that property prices may start to decrease two years ahead of financial distress.<sup>54</sup> It may be justified to say that the real estate cycle may cause financial distress (with a time lag) and not the other way around. However, it does not mean that bank lending is not critical to the development of the real estate cycle. In essence, the availability of property lending would affect the development of the property market. In the upswing of the property market, too much property lending may help the formation of the property bubble, and in the downswing, the withdrawal of property lending would exaggerate decreases in property prices. It is quite likely that the faster the withdrawal of property lending is, the higher the volatility of the property market.

One of the reasons for revision of Basel I was to introduce a more sensitive risk management mechanism, and the standardized approach and the IRB approach are indeed more sensitive to risks than the approach provided by Basel I. The standardized approach does not require banking institutions to update the credit rating of borrowers, but the difference in treatment among developers provides banking institutions a chance to adjust the risk weights of property lending in good time. Presuming the ratings provided by external credit rating agencies would reflect the change in market conditions, it can be expected that a decrease in property prices would restrain property lending earlier than before.

The IRB approach provides a relatively short forecasting period for PD estimates. PD estimates for each grade must be done at least once a year as the minimum input under the IRB approach.<sup>55</sup> In other words, banking institutions are given at least one opportunity to adjust the risk weight with respect to property lending per year. Therefore, the change in the property market would be reflected at most for one year afterwards.

These provisions will be advantageous to banking institutions because a more sensitive approach could improve the soundness of the banking system. However, they may not have the same effect on the property market. When the property market is in the downward phase, banking institutions may be forced to decrease their property lending activities and re-allocate

assets classes.<sup>56</sup> This could lead to liquidity problems in the real estate market over the short term. The real estate cycle could therefore be exaggerated by the implementation of Basel II. The more the property market relies on property lending, the bigger the impact of Basel II on the real estate cycle.

Nevertheless, the relationship between the real estate cycle and banks' loans would be weakened due to the diversification of funding channels. Traditionally, banks' loans are the prominent funding source for the property market. As financial derivatives are created, the funding channels of the property market are also extended. The implementation of Basel II may increase the cost of property lending for developers, which would push developers to seek more funding channels. This will partly reduce the negative impact of Basel II on the real estate cycle.

## CONCLUSION

The readjustment of risk weights across the different classified risks under Basel II changes the determination of risk-based capital adequacy measures required by each type of risk exposure. Banks are required to increase risk capital for loans with higher risk weights. This in turn will shift the banks' asset allocation and lending policies in favor of the cost and return tradeoffs across the different classes of assets held by the banks. In Hong Kong where more than 50 percent of the banks' assets are related to the property market, the implementation of Basel II has wide impact on the various sectors within the property market.

First of all, the new distribution of risk weights across different risk classes will induce banks to shift more of their lending originally designated for the small and medium sized developers to big developers. Since the smaller developers do not have equal access to equity capital as the big developers, they must rely on debt in the form of bank loans as the major source of capital. The shift in lending policy of banks will only deepen the already highly oligopolistic market structure in property development in Hong Kong.

Prior to Basel II, the risk weight assigned to property-holding shell company was 100 percent. The implementation of Basel II results in Capital Rules with three risk weights, 35 percent, 75 percent and 100 percent for property-holding shell companies. The risk-adjusted incentive favors banks

to allocate more of their assets to this kind of company and bank loans become more easily accessible to them, possibly with lower interest as well.

For residential mortgages, the implementation of Basel II in Hong Kong reduces the risk weight from 50 percent to 35 percent, which would increase the preference of banking institutions for residential mortgage. Banks in Hong Kong have very high credit risk concentration in the property sector. Bank lending to the property sector, including loans for building and construction, property development and investment, and for the purchase of residential property, accounts for more than 50 percent of total lending. Residential mortgages alone already account for more than 30 percent in December 2006.<sup>57</sup> It is expected that the implementation of Basel II will encourage banks to increase their lending in the form of residential mortgages and hence further worsen the already very high concentration of credit risk in the property sector, which may make the bank system unsound.

Basel II has already been implemented in a number of jurisdictions including Hong Kong. The change in calculation methods for the capital adequacy ratio would consequently change the lending attitudes of banking institutions and their respective preferences. In Hong Kong, the close relationship between the property market and bank lending illustrates that the impact on our local property market may be more serious than that of other jurisdictions. In sum, this impact may be summarized in the following points: (1) exacerbating the oligopoly in the property market, i.e., the situation for small and medium developers would be worse than before; (2) increasing the cost of financing from banking institutions (bank lending) for developers, which may cause the diversification of financing channels of real estate; and (3) more importantly, bringing about an unintended and undesirable effect on the real estate cycle possibly through exaggerating price instability.

## FORMULA 1

$$\begin{aligned} \text{Correlation (R)} &= 0.12 \times (1 - \text{EXP}(-50 \times \text{PD})) / (1 - \text{EXP}(-50)) + \\ &\quad 0.24 \times [1 - (1 - \text{EXP}(-50 \times \text{PD})) / (1 - \text{EXP}(-50))] \\ \text{Maturity adjustment (b)} &= (0.11852 - 0.05478 \times \ln(\text{PD}))^2 \end{aligned}$$

Capital requirement (K) = [LGD x N [(1-R) ^-0.5 x G (PD) + (R/(1-R))  
^0.5 x G(0.999)] - PD x LGD] x (1-1.5 x b) ^ -1 x (1 + (M-2.5) x b)

Risk-weighted assets (RWA) = K x 12.5 x EAD

Source: Basel Committee on Banking Supervision (2005), *International Convergence of Capital Measurement and Capital Standards (A Revised Framework)*, Part 2, Section III C 1 (i).

## FORMULA 2

Correlation (R) = 0.15

Capital requirement (K) = LGD x N [(1-R) ^-0.5 x G (PD) + (R / (1-R))  
^0.5 x G(0.999)] - PD x LGD

Risk-weighted assets (RWA) = K x 12.5 x EAD

Source: Basel Committee on Banking Supervision (2005), *International Convergence of Capital Measurement and Capital Standards (A Revised Framework)*, Part 2, Section III D 1(i).

## NOTES

<sup>1</sup> Basel Committee on Banking Supervision (July 1988), "International Convergence of Capital Measurement and Capital Standards," <http://www.bis.org/publ/bcbs04a.pdf> (visited on 16 March, 2008).

<sup>2</sup> H. P. Tarbert, "Rethinking Capital Adequacy: the Basel Accord and the New Framework," 56 *Bus. Lawyer* 767.

<sup>3</sup> Basel Committee on Banking Supervision (2005), "International Convergence of Capital Measurement and Capital Standards (A Revised Framework)," <http://www.bis.org/publ/bcbs118.pdf> (visited on 16 March, 2008).

<sup>4</sup> *Supra* note 1.

<sup>5</sup> *Supra* note 3, Part 2, Section II A 8.

<sup>6</sup> *Id.* Part 2, Section II A 9.

<sup>7</sup> *Id.*, Part 2, Section III A.

<sup>8</sup> *Id.*, Part 2, Section III B 2.

<sup>9</sup> Corporate exposure is defined as a debt obligation of a corporation, partnership, or proprietorship. *See id.*, Part 2 Section III B 1 (i).

<sup>10</sup> Retail exposure should meet the following criteria: (1) exposures to individuals, (2) residential mortgage loans, (3) loans extended to small business if the total exposure of the banking group to a small business borrower (on a consolidated basis where applicable) is less than €1 million, and (4) supervisors have flexibility in the practical application of such thresholds. *See id.*, Part 2 Section III B 1 (iv).

<sup>11</sup> *Id.*, Part 2 Section II A 8 and Part 2 Section III D 1 (i).

<sup>12</sup> *Id.*, Part 2 Section III B 2 (ii).

<sup>13</sup> SME borrowers mean corporate exposures where the reported sales for the consolidated group of which the firm is a part is less than €50 million. *See id.* Part 2 Section III C 1 (ii).

<sup>14</sup> S is expressed as total annual sales in millions of euros of S falling in the range of equal to or less than €50 million or greater than or equal to € million.

<sup>15</sup> *Id.* Part 2 Section III C 1 (i).

<sup>16</sup> Basel II provides that the SL possesses all the following characteristics, either in legal form or economic substance: (1) the exposure is typically to an entity (often a special purpose entity) which was created specifically to finance and/or operate physical assets, (2) the borrowing entity has little or no other material assets or activities, and therefore little or no independent capacity to repay the obligation, apart from the income that it receives from the asset(s) being financed, (3) the terms of the obligation give the lender a substantial degree of control over the asset(s) and the income that it generates, and (4) as a result of the preceding factors, the primary source of repayment of the obligation is the income generated by the asset(s). *See id.* Part 2 Section III B 1 (i).

<sup>17</sup> *Id.*, Part 2 Section III B 1 (i).

<sup>18</sup> *Id.*, Part 2 Section III B 1 (i).

<sup>19</sup> *Id.*, Part 2 Section III C 1 (iii).

<sup>20</sup> The HKMA, "Proposals for the Implementation of the New Capital Adequacy Standards ("Basel II") in Hong Kong," [http://www.info.gov.hk/hkma/eng/basel2/Consultation\\_04.pdf](http://www.info.gov.hk/hkma/eng/basel2/Consultation_04.pdf) (visited on 16 March, 2008).

<sup>21</sup> Banking (Amendment) Bill 2005, <http://www.legco.gov.hk/yr04-05/english/bills/b0503041.pdf> (visited on 16 March, 2008).

<sup>22</sup> Banking (Capital) Rules (Cap. 155L).

<sup>23</sup> Banking (Disclosure) Rules (Cap. 155M).

<sup>24</sup> Small AI means the AI which at the end of its financial year immediately preceding the date of the application, the AI and its consolidation group, if any, each

had total assets, before deducting any specific provisions or collective provisions, of not more than \$10 billion. Section 7 of the Banking (Capital) Rule provides that except for the AIs intending to implement the IRB approach, the AI would be granted the approval by the HKMA only if it satisfies the foregoing requirements and there is no cause to believe that the use of the Basic approach to calculate its credit risk for non-securitization exposures would not adequately identify, assess and reflect the credit risk of the institution's non-securitization exposures taking into account the nature of the institution's business. See Section 7, *supra* note 22.

<sup>25</sup> Legislative Council Brief, Banking (Amendment) Bill 2005 (File Ref.: g4/16/36C), [http://www.legco.gov.hk/yr04-05/english/bills/brief/b12\\_brf.pdf](http://www.legco.gov.hk/yr04-05/english/bills/brief/b12_brf.pdf) (visited on 16 March, 2008).

<sup>26</sup> The HKMA, Banking(Capital) Rules (Explanatory Paper), [http://www.info.gov.hk/hkma/eng/basel2/banking\\_capital\\_rules/Explanatory\\_Paper.pdf](http://www.info.gov.hk/hkma/eng/basel2/banking_capital_rules/Explanatory_Paper.pdf) (visited on 16 March, 2008).

<sup>27</sup> Section 108, *supra* note 22.

<sup>28</sup> *Supra* note 1.

<sup>29</sup> Section 61, *supra* note 22.

<sup>30</sup> Data are from the credit rating list of Standard & Poor's. See [http://www2.standardandpoors.com/portal/site/sp/en/ap/page.topic/ratings\\_corp/2,1,3,0,0,0,0,0,0,0,4,0,0,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/ap/page.topic/ratings_corp/2,1,3,0,0,0,0,0,0,0,4,0,0,0,0,0.html) (visited on 15 March, 2008).

<sup>31</sup> Standard & Poor's, "S&P Corporate Rating Criteria (2006)," p. 21. [http://www2.standardandpoors.com/spf/pdf/fixedincome/corporateratings\\_052007.pdf](http://www2.standardandpoors.com/spf/pdf/fixedincome/corporateratings_052007.pdf) (visited on 15 March, 2008).

<sup>32</sup> Hysan, "Annual Report (2006)," see [http://www.hysan.com.hk/chi/cmsdoc/annual\\_report\\_c/AR2006\\_C.pdf](http://www.hysan.com.hk/chi/cmsdoc/annual_report_c/AR2006_C.pdf) (visited on 15 March, 2008).

<sup>33</sup> [http://www.shkp.com/en/scripts/investors/invest\\_ratings.php](http://www.shkp.com/en/scripts/investors/invest_ratings.php).

<sup>34</sup> [http://www2.standardandpoors.com/portal/site/sp/en/ap/page.topic/ratings\\_corp/2,1,3,0,0,0,0,0,0,0,4,0,1,0,0,0.html](http://www2.standardandpoors.com/portal/site/sp/en/ap/page.topic/ratings_corp/2,1,3,0,0,0,0,0,0,0,4,0,1,0,0,0.html) (visited on 15 March, 2008).

<sup>35</sup> *Supra* note 31, p. 22.

<sup>36</sup> P. Christoph, B.W. Stephan, "The Impact of the New Basel Capital Accord on Real Estate Developers," 24:1 (2006) *Journal of Property Investment & Finance*, pp.7-26.

<sup>37</sup> Standard & Poor's, "Standard & Poor's Rating Services U.S. Ratings Fees Disclosure." <http://www2.standardandpoors.com/spf/pdf/fixedincome/RatingsFees2008.pdf> (visited on 15 March, 2008).

<sup>38</sup> The HKMA, "Basel II- External Credit Assessment Institutions' Ratings and Mapping of Ratings to Risk-Weights," [http://www.info.gov.hk/hkma/eng/basel2/Ltr%20to%20AI\\_ECAIs\\_ratings\\_mapping\(23Jun\).pdf](http://www.info.gov.hk/hkma/eng/basel2/Ltr%20to%20AI_ECAIs_ratings_mapping(23Jun).pdf) (visited on 15 March, 2008).

<sup>39</sup> G. Ferri, T. S. Kang, J. Y. Lee, "New Basel Accord and Requirements for ECAI

Recognition from Asian Developing Countries' Perspective," [http://www.kdi.re.kr/upload/7808/a2\\_3\\_2.pdf](http://www.kdi.re.kr/upload/7808/a2_3_2.pdf) (visited on 15 March, 2008).

<sup>40</sup> *Id.*

<sup>41</sup> For example, there are strict requirements for the equity securities in Hong Kong, which will restrain the ability of small and medium developers to finance in the securities market. The issuer must satisfy either the profit test or the market capitalization/revenue/cash flow test or the market capitalization/revenue test. These tests require the minimum of the market capitalization or the profit attributable to shareholders. Taking the capitalization/revenue test as an example; it requires that the issuer shall have a market capitalization of at least HK\$4,000,000,000 at the time of listing, and revenue of at least HK\$500,000,000 for the most recent audited financial year. *See* Section 8.05, Rules Governing the Listing of Securities of the Stock Exchange of Hong Kong Limited. [http://www.hkex.com.hk/rule/listrules/vol1\\_2.htm](http://www.hkex.com.hk/rule/listrules/vol1_2.htm).

<sup>42</sup> Consumer Council (1996), "How Competitive Is the Private Residential Property Market?"

<sup>43</sup> Section 2 (1), *supra* note 22.

<sup>44</sup> *Id.*, Section 65(1).

<sup>45</sup> *Id.*, Section 65 (4) (a).

<sup>46</sup> *Id.*, Section 65 (4) (b) and 64 (9).

<sup>47</sup> *Id.*, Section 115.

<sup>48</sup> The HKMA, "Press Release: 70% Loan to Value Ratio (31 July 1998)," <http://www.info.gov.hk/hkma/eng/press/1998/980731e.htm> (visited on 15 March, 2008).

<sup>49</sup> B. F.C. Hsu, D. Arner, F. Pretorius, "Beyond the Basel Accord: Should the Capital Adequacy Ratio Take Account of The Real Estate Environment in the Hong Kong SAR?," 124:4(2007) *The Banking Law Journal*, pp.297-308.

<sup>50</sup> <http://www.info.gov.hk/hkma/eng/statistics/msb/attach/T030503.xls> (visited on 15 March, 2008).

<sup>51</sup> The HKMA, "Residential Mortgages Survey Results" of the relevant months (1998-2006) <http://www.info.gov.hk/hkma/eng/press/index.htm>.

<sup>52</sup> G. A. Goodman, R. W. Becker, "The New Basel II Capital Accord: Business and Legal Challenges for Real Estate Lenders," 120: 4 (2003) *The Banking Law Journal*, pp. 309-318.

<sup>53</sup> For example, the financial crisis in U.S. in the 1980s, in Japan and Thailand in the 1990s, *see* R. Herring, S. Wachter (1998), "Real Estate Booms and Banking Busts: An International Perspective." Paper presented at the Wharton Conference on Asian Twin Financial Crises, The Long-Term Credit Bank, Tokyo, Japan; B. Renaud, "The 1985 to 1994 Global Real Estate Cycle: An Overview," 5:1 (1997)

*Journal of Real Estate Literature*, pp. 13-44.

<sup>54</sup> P. Hilbers, Q. Lei and L. Zacho, "Real Estate Market developments and Financial Sector Soundness," IMF Working Paper (WP/01/129, Sept. 2001), p. 29.

<sup>55</sup> *Supra* note 36.

<sup>56</sup> *Supra* note 52.

<sup>57</sup> *Supra* note 50.

## DIRECTORS' PERSPECTIVE

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CHRISTOPHER J. ZINSKI

### CRUNCH, MORE CRUNCH AND REACT: THE CASE OF THE SILVER LINING DUET

Leonard had never asked for the job of lead director but his brethren on the board of directors of Big-Blue-Clouds Bancorporation, or “Clouds” as it was known locally, had handed him the honor several years ago. This was an affable group of directors and the chairman and CEO worked well with the board. Occasionally, Leonard chaired an executive session of the board or led a discussion in a regular meeting. Beyond those activities, his lead status had received little time and attention, and with this he was fine.

2008 had been the year he planned to retire from Clouds’ board. He and his director compatriot — Johnnie Vision — each had told the company’s chairman that he intended to roll off the board at the time of the stockholders meeting, having collectively served the organization as directors for three decades. Leonard and Johnnie had been close friends since college, forging a perpetual bond when they first met one another during a spring break trip freshman year to Bermuda. They reminisced about the trip, often remembering the warm breeze, their bright Hawaiian shirts, and those carefree days.

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Leonard had gone off to start a high tech company that he sold three years ago for eight figures, while Johnnie had created a franchise of optical stores that he planned to cash out of soon. Neither had financial worries and each looked forward to extended trips together with their wives after giving up their commitment to attend board meetings for Clouds and after Johnnie handed his company over to his investment bankers for the liquidity event of a lifetime. An anniversary trip back to Bermuda was in their future. They talked several times a day and the chairman bragged about town that each of them was the strongest director on his board, and he hoped they would serve together for many more years. They were respected and needed as part of the Clouds organization.

Leonard had become very uneasy in recent months about the headlines in the financial press. Johnnie had shared his concerns too, which were very personal, that the financial stress in the markets might cause deterioration in the market value of his optical company and he would likely have to postpone his much planned for liquidity breakthrough. For several months the credit markets had been tightening and all financial institutions, including Clouds, had pulled back, assuming a more conservative business stance. Leonard had seen Clouds' loan origination numbers plateau in the past quarter, and the CEO had volunteered that he had instructed his lending officers to moderate their loan acquisition activities pending further information about the state of the economy.

Johnnie and Leonard had been more attentive than normal to developments broadcast over the cable news stations about the challenging economic conditions. Rising oil prices, further deterioration in the dollar, the sub-prime mortgage mess, disruption in the collateralized debt obligation market and the huge write-offs taken by the world's largest financial institutions were weighing heavily on their minds. Despite the pullback in lending, Clouds seemed to be doing just fine weathering the challenging market conditions.

So what, Leonard mused, if Clouds' assets hovered around \$12 billion for a couple of years so long as its earnings and return on equity held up. Stockholders understood as well as Leonard and Johnnie that times were tough, and this was just another typical cycle in the up and down, ebb and flow of the economy and real estate market. Indeed Clouds' unusually

strong balance sheet might even encourage investors to flee to its stock as other financial institutions suffered duress in the current environment. Leonard saw the possibilities and, on balance, he was fairly optimistic. Yet something continued to gnaw at him. As lead director, should he be doing more? Was something going on below the surface of Clouds' consolidated financial statements that might be corroding the Company's earnings prospects? Was there something he and the other directors didn't immediately see that threatened Clouds' long term financial well being?

As much as Leonard wanted to dwell on the pleasures associated with his retirement from the Clouds board and the carefree days ahead with Johnnie on the golf course in Bermuda, he felt a sense of obligation to Clouds and its stockholders that he couldn't shake off as much as he tried. He knew Johnnie felt the same way from their many conversations in past weeks. Perhaps the greatest contribution in their collective three decades of service to Clouds would be to challenge the board to think through enterprise risk issues in the current operating environment. Leonard determined to set an agenda for the next meeting of the board, previewing it in advance with the chairman and CEO, that would provoke discussion in the boardroom about Clouds' preparedness to deal with the seemingly acute market headwinds.

Johnnie enthusiastically endorsed Leonard's idea to surface key risk management issues at the next board meeting. Despite the distractions of his own with the prospects for the sale of his company waning, Johnnie engaged Leonard in an agenda-setting conversation that covered the many issues they thought should be covered by the board under current market circumstances.

"Leonard, let's pencil out a mini-agenda for the next board meeting where we can walk the board through a discussion of risk management issues given the external environment. We can't do this too soon in my opinion. I'm not superstitious but I had a dream — a vision — the other night," relayed Johnnie, "in which we went through a regulatory exam and a majority of our credits were double and triple downgraded; we were required to massively upsize our allowance for loan losses. On top of the disastrous financial consequences that those circumstances had for Clouds, the regulators put us under a regulatory order that stopped our growth and imposed onerous new operating parameters. I can do without these kinds of visions,

Leonard. I'd much rather dream about the good old days in Bermuda."

"I can immediately think of five or six things we should cover with the board," said Leonard. "Let's rough those out and see what the rest of the board thinks about them. We'll want to walk through these ideas with the CEO before the board meeting so he can be prepared to answer our questions."

### Effectiveness of Risk Monitoring Systems

"The economy and banking industry," remarked Johnnie, "are in an apparent downturn. This is a real test of Clouds' risk monitoring systems.

We should be paying attention at the board level to what our risk reporting systems are telling us. Are we getting good, real-time information? You might expect to see an up-tick in credit quality problems in this environment and slower loan growth. On the other hand, customers may be fleeing to insured deposits from riskier equity investments and mutual funds, which may help our balance sheet on the funding side."

"I'd take your comments a step further," Leonard responded. "Management and the board should experience some changes in our financial performance as a result of the economic downturn. But another aspect of this is whether our risk monitoring systems are picking up on trends before they are upon us. In other words, are we learning about credit quality problems when they become severe problems or do our risk monitoring systems give us some forewarning of what is about to happen to our portfolio? Are we able to see weaknesses in our earnings and balance sheet before those weaknesses actually appear in any material way or become severe?"

"Some things are predictable and others aren't. Each of us has been in business a long time. I'm not a great predictor of the future. When I'm optimistic about my company's earnings they end up being soft for the year. When I'm pessimistic about things, they turn out fine or I'm surprised by my company's strong performance. Forecasting future financial performance is a tricky thing, especially so when the external environment changes so rapidly as it has with the current credit crunch. No one would have predicted the depth of the housing slump and the ripple effect that

has had across the globe, let alone the severity of the financial losses these developments have imposed on many brand-name institutions. New unanticipated problems seem to arise every day.”

“I agree,” said Leonard, “but there are some things that are predictable. We’re not necessarily asking management to speculate with precision about the future. Rather, we are asking whether Clouds’ basic risk monitoring systems are giving any indication that there are red flags on the horizon. If the answer is ‘no’ and trouble doesn’t eventually appear we can have confidence the systems are working. If the answer is ‘yes’ and trouble appears we have similar confidence. I worry about the scenario were we get a false negative. That is, if our predictive indicators are picking up no weaknesses or trouble-spots but nevertheless we end up in material financial distress, then we have a disconnect between our warning systems and reality.”

“What kinds of risk management systems should we be evaluating?” queried Johnnie.

“That’s a good question. Actually, we should put that question to management and ask them to explain the basic risk monitoring tools they use to navigate the current environment. But several possibilities come to mind. We can look at trends relating to non-performing assets, delinquent loans, other real estate owned, and our loan watchlist. Are we seeing unusual increases in assets in these categories and, if so, what are the characteristics of the changes and what do these weaknesses mean? We can ask management to benchmark these problem asset categories against our peer banks. Trend lines are important year over year and on a month-to-month sequential basis. Are there certain types of borrowers under more financial duress than others in the current environment and what systems do we use to monitor the duress?”

“I’m tracking you, Leonard,” commented Johnnie. “We can also focus on our loan production reports. We know the CEO has put the word out to slow down loan growth in this environment, and we have seen a slow-down in our quarterly financial reports for the last two periods. But is that caused by our own actions or is it a result of the marketplace or a combination of both? What categories of credits are experiencing the most slow-down? Can we predict how much our loan volume may decline through

the rest of the year and the effect that will have on earnings? How does our loan volume compare to our peers? You could even make the argument that in this environment we should be more aggressive in lending as our competitors turn down credits. It may be an opportunity to grab market share. The fundamental question is what the quantitative information about loan volumes tells us about our future balance sheet and earnings prospects, and we should get a better understanding of the causes for changes in loan volume.”

“If we have solid risk monitoring systems, management will be able to react early and maybe even in a pre-emptive way to deteriorating market conditions. If not, the credit crunch may cause management reactions that are ill timed or incorrect for impending problems. If we see a ‘crunch-crunch-and-react’ scenario, we should be asking ourselves whether our risk monitoring systems are as predictive as they should be, understanding that it is difficult to gauge with precision how changes in the external environment will affect our financial condition.”

## Liquidity and Capital Management

“This is a tough operating environment for banks right now,” remarked Leonard, “and fundamental to any bank, including Clouds, is managing its liquidity and capital position to regulatory standards. If our balance sheet is in flux, focusing on our liquidity and capital position is very important.”

“My sense is we have a strong liquidity and capital position based on the reports we are getting at the board level and management’s presentations to the board. But I wonder if liquidity and capital are being stressed tested. That is, what environmental factors could cause a rapid and severe deterioration in our liquidity or capital position?”

“If credit quality deteriorated rapidly,” responded Leonard, “and we took large unexpected charge-offs and, as a consequence, increased our provision for loan losses those types of developments could ‘shock’ our capital position.”

“Likewise, if credit deteriorates and we publicize that deterioration to the market through a press release or even if rumors start in the market-

place about a weak credit portfolio, it is conceivable that we lose some of our deposits as our clients worry about our financial well-being and gravitate to more solid banks with their savings. That could put some pressure on liquidity.”

“Here’s what I would like to see from management,” concluded Johnnie. “I would like to understand our current capital and liquidity position and an explanation of what realistically could happen — best and worse case scenario — to our bank in the next 12 months that would materially jeopardize our capital and liquidity positions. A countervailing factor is that loan growth is slowing down and accordingly our capital is not going to be allocated to support rapid loan growth as it has in the past. So maybe we don’t have any real concerns about our capital position. All I know is every time the regulators examine Clouds, liquidity and capital are two factors they test for. So, if those factors are important in the examination process, they should be important to our board when the company, indeed the industry, is going through a stress cycle.”

“I agree. What we are really asking management to do is give us comfort that we have enough ammunition in our arsenal — cash and cash equivalents and capital — to weather a tough, protracted battle. We don’t need to know whether we can make it through catastrophic conditions, but rather we need to know realistically how bad it could get and whether we can make it through that period. If we can’t make it with current resources, we need to understand our options now and start thinking through those on a contingency basis.”

## Regulatory Relations

“We just discussed something in the last few minutes on liquidity and capital management,” remarked Johnnie, “that bears some further discussion. We spoke about liquidity and capital management as issues important to the regulators in the exam process. If the industry is in such a terrific downturn, which it appears it may be from the number of threatened bank failures occurring and depressed earnings announced by many financial institutions, shouldn’t we be proactive in building the relationship with our regulators?”

“We know our problems, if we have problems, will only be more acute if the regulators are in an adversarial relationship with us. No one likes surprises and that includes our regulators. I see value in having management keep in close contact with our regulators during this period of market stress. It may be that management already is doing something like this. But I think it is worth exploring with management during the board meeting.”

“Managing the regulatory relationship is management’s job, and I’m not going to second guess management’s approach. But I would like to understand its approach. At the end of the day, the board is responsible for supervising management and the institution. Any regulatory problems will end up in front of the board and the board may be subject to criticism. So we have a right to ask the question about how management is managing the regulatory relationship. If it isn’t being managed proactively, perhaps a gentle nudge by us will prove valuable to the organization.”

“I don’t see any downside to keeping the lines of communication open with the regulators. Indeed the biggest advantage may be that management can learn which ‘hot buttons’ the regulators have at any point in time and the trends the regulators are seeing at other organizations. Knowing those trends may help management avoid some trouble-spots and is consistent with having a risk identification system that spots potential problems before they develop.”

“If we do run into a credit quality, capital or earnings problem that is severe enough for the regulators to want to pursue an enforcement action against the organization, having been up-front with the regulators and proactive in communicating can only help us when we try to negotiate a more favorable outcome to the regulatory criticism.”

## Crisis Management

“If you open the paper everyday, you read about the next new financial crisis. The downturn in the housing market led to the credit crunch. That caused huge losses in mortgage-related investments and a crisis in the auction-rate securities market. In an environment like this, things change quickly, sometimes overnight. Out of the blue, a handful of financial institutions announced material write-offs of goodwill related to acquisitions they had made because value was determined to be impaired. This

is a very unusual and in many respects unstable operating environment.”

“You’re right, Leonard,” remarked Johnnie, “we also are starting to see an up-tick in regulatory actions relating to credit quality where the regulators are compelling institutions to increase their allowance for loan losses.

The news articles I have read suggest those regulatory interventions have been a surprise to the target institution. I sure hope Clouds doesn’t have any latent regulatory problems.”

“The fact is Clouds could run into unusual and severe problems in this operating environment abruptly whether it involves a credit quality issue, a goodwill write-off charge, problems with the valuation of its investment portfolio or liquidity pressure,” responded Leonard. “We have to be ready to respond to rapid deterioration in our balance sheet or earnings or both, but we have to understand, as we discussed earlier, the possibility of that kind of unexpected stress on our financial condition or earnings. The first step is to identify where our key risks lie and have a process in place to address those risks should they materialize.”

“Let’s not forget, too, that much of our business is the result of our stellar reputation in our market. Some of the rapid disruptions you mention that could adversely affect our business may also cause us some reputational harm. If depositors think the bank has severe financial problems we may see deposit outflows. The point is we have to have a media and public relations arrangement in place if things deteriorate.”

“I’m not so worried,” said Leonard, “about having a written plan to deal with any major crisis that may arise as I am that management has thought about the possibility of a crisis and how it would manage it. Management has the responsibility for developing the plan to handle the unexpected situation. I want to test whether management has been thinking about what could go wrong in the current environment and how they would respond if it did.”

## Staying Macro and True to the Strategic Plan

“If a significant financial issue surprised us it has the potential to distract management. Even trying to navigate Clouds through the current difficult banking and credit environment may distract management,”

opined Johnnie, “from its strategic mission.”

“Distractions are a natural consequence of significant unforeseen problems and even the risk of those problems can pull management’s eye off the ball. But it can also distract the board. Management and the board need to be disciplined to stay focused on the big picture and continue to pursue Clouds’ strategic plan even if things are not going well.”

“I think what you are saying, Leonard, is that if Clouds changes its strategy it should be done affirmatively. That is, we should not unintentionally veer off course or recoil from our stated goals.”

“That’s right,” said Leonard. “There may be good reason to revisit our strategy if we think it is no longer working in the current operating environment. For instance, many banks shut down or sold off their sub-prime or conventional mortgage business when the housing market took a severe downturn. If some of our branch offices become poor performers, we might want to consider selling them and holding off on building new ones; to date, we have just continued to build new branch offices. But those determinations should be made after careful consideration.”

“As always,” responded Johnnie, “the board has to be attentive to supervising management and doing so at a high altitude. We shouldn’t be micromanaging Clouds. There is a tendency for the board to drill down on issues when they arise. I’m not saying we shouldn’t be briefed on significant problems that jeopardize our earnings. But we should bring a measured response and let management do the managing.”

“As a final point on this topic,” continued Leonard, “as a board we have to emphasize at all times, and particularly when times are tough, that the tone at the top is imperative to our continuing success. The real character of a management team is measured when the pathway to success is not clear and there are significant hurdles presented. We have a great management team with great integrity. We have to be vigilant that they remain true to that value system during the ups and the downs of the market.”

## Keeping an Eye on Regulatory Compliance

“When things go wrong,” remarked Johnnie, “they often can go very wrong. In a highly regulated industry like banking, we always have to keep

an eye on our regulatory compliance. When our people are stressed to find new lending opportunities or to cut costs, we need to be sure we aren't cutting corners and increasing our compliance risk."

"This is so true. A tough credit market and pressure on earnings can prove a major distraction for management. Resources may be diverted from regulatory compliance to other areas of the organization and compliance takes a backseat to other more pressing business issues and demands. We need to ask questions of management about their continued commitment to compliance."

"I would take it a step further," continued Johnnie. "I think our audit committee should actually step up its inquiries concerning compliance process and procedure in this kind of environment. It should be more probative than ever. If it sees staff and resources diminish in the compliance function, it should ask why. If compliance has fallen off committee and board agendas, we should be asking some questions."

"A compliance violation can cost the bank dearly in terms of remediation costs, reputational risks, and regulatory encumbrances on our business. It is very easy to become lax about compliance when management is fighting seemingly more serious fires. Staying true to a solid compliance function during a tough credit market is good management, and the board needs to remain vigilant in testing that compliance procedures are working and the function is given continued emphasis."

## The Silver Lining

"Who could have predicted the credit crunch that began in 2007 let alone its severity? The ripple effect in so many areas of the economy and array of different types of financial instruments is amazing," commented Johnnie.

"How quickly things changed really surprised me," responded Leonard. "These are treacherous waters for sure and being prepared to respond to balance sheet and earnings hits is important. Despite the stress on management and the choppy water ahead, there is a silver lining to all of this."

"It is hard for me to imagine the silver lining, Leonard. What is it?"

“It is what we have been talking about for the past hour or so. This difficult operating environment causes outside directors like you and me to dig in and think through whether our risk management systems are adequate and develop questions that test management’s preparedness to deal with the challenges. This is active engagement that reflects good corporate governance; it is the silver lining in these stressful times. I am convinced management is prepared. But asking the right questions at the board level demonstrates we are exercising our fiduciary duties.”

## TECHNOLOGY, LAW, AND BANKING

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JAMES F. BAUERLE

### THE DAY THE DAM BROKE: RECONSTRUCTING REGULATION IN THE ERA OF TECHNOLOGY-BASED FINANCIAL SERVICES

On a rainy May weekend 119 years ago, Johnstown, Pennsylvania became synonymous with natural disaster when an earthen dam at the South Fork Fishing and Hunting Club failed, causing a 60 foot high wall of water to crash into the city center at a speed of 40 miles per hour. Nearly as many souls perished as in the 2001 World Trade Center calamity. The spectacle was equally gruesome. Many who escaped drowning burned to death as their wooden homes, stores, and churches fueled fires ignited by overturned stoves and furnaces. The debris field piled up against the Pennsylvania Railroad's stone bridge over the Conemaugh River, so completely entangled there that rescue workers could not dismantle it. Only dynamite brought an end to the burning pile of rubble and human remains. After the Johnstown flood, state legislators introduced dam safety legislation, but failed repeatedly to win its enactment.

Austin, Pennsylvania, lies 145 miles north of Johnstown at another mountain intersection in the Alleghenies. To offset the timber industry's declining employment, county officials in 1900 persuaded George Bayless to build a paper mill in Austin. The mill employed 200 men. Seasonal water shortages led Bayless to construct a dam that impounded 275 million gallons of water between the steep sides of the mountain valley north of Austin.

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The dam's creation was considered a significant engineering feat. Constructed of steel-reinforced concrete, it stretched 534 feet across the valley and rose 50 feet from the valley floor. When it broke in 1911, the dam sent a 50 foot high wall of water across Austin, leading eyewitnesses to describe uprooted houses as corks bobbing on the raging torrent.

Pennsylvania rejected disaster assistance appeals made on behalf of Austin flood victims. State Senator F.A. Baldwin responded indignantly, "One cannot defend property rights at the expense of human rights." His sister and elderly parents perished in the flood. Two years later, the Pennsylvania legislature enacted the Water Obstructions Act of 1913, which had been proposed after the Johnstown flood, but was blocked repeatedly by powerful commercial interests. The law was the first dam safety statute in the United States.

The Johnstown and Austin flood stories make interesting historical reading. Yet they seem terribly remote — artifacts of a frontier era — in a time when we take for granted sound design and construction of dams, roads, and bridges, and when failures are few. As the nation grapples again with the wreckage of indiscriminate behavior in the financial markets, this installment of "Technology, Law, and Banking" considers how the growing influence of technology over the financial services industry — a change as dramatic as civil engineering advances in the early Industrial Age — has created new risks, blinded market participants to potential calamities, and made the established order of financial services regulation ineffective. Concepts are offered around which market regulation can be reordered. And suggestions are made for implementing such a reordering.

## Failed Engineering and False Beliefs

Not quite 30 years ago, Yale Professor James Tobin won the Nobel Prize in economics for elucidating the relationship — theoretical and practical — between risk and return in economic transactions and relationships. In the same decade, Louis Ranieri and his colleagues at Salomon Brothers created asset securitization by pooling mortgages and issuing securities whose repayment was secured by assignment of the underlying payment streams from the consumer borrowers whose mortgages were included in a particular pool. The intervening period has witnessed a dizzying rush to securitize every con-

ceivable asset class, from mortgages to rock star David Bowie's future earnings. Ranieri remarked recently that the securitization market had grown so large and so complex that he hardly recognized it. One can infer that he also considered the market ripe for a fall.

In the search for causes of the recent turmoil in the capital markets — typified by the government-directed resolution of Bear Stearns' distress — the strong early evidence points to a deadly combination of bad financial engineering and human error, compounded by the absence of effective oversight of market participants by the U.S. government agencies charged with that responsibility. Failed financial engineering led to astounding default and loss rates for large pools of mortgage-backed securities. How could financial engineers — bankers and lawyers whose livelihood depends on an orderly market for the securities they create — get it so wrong?

### *Bad Assumptions*

Securitization model builders, and many buyers of mortgage-backed securities, put their faith in regression analyses that showed that consumers always find a way to pay their mortgage debt. Study after study demonstrated this reality over the better part of a century. Not taken into account were the perils of easy credit, including particularly the interest rate risk created by new products like option adjustable rate mortgages. When the dam burst, consumers lacked liquidity, equity and the flexibility needed to adjust for changed market conditions.

### *Behavior Shaped by Desire*

People believe what they desire to believe. Securitization model builders believe the data output created by their models because of their considerable financial and psychic investment in building and running the models. Consumers believe they will be able to pay back the loan that absorbs 43 percent of their monthly income because they desire to live in the house behind the white picket fence with three cars in the driveway. A retired executive from one of the nation's leading turnaround management firms told the author two years ago how much money he was earning as a hard-money

lender to Florida homeowners with poor credit. From the proceeds of the loans he made, he withheld 13 monthly payments and paid them to himself, one month at a time, to assure that the borrower built a better credit score that would enable refinancing 13 months later. Asked what he would do if the mortgage market experienced a liquidity crisis, he replied, "I had not thought of that." This from a man who made his fortune rescuing businesses from financial distress!

### *Danger Signs Disregarded*

Louis Ranieri was not alone in recognizing how supercharged the mortgage securitization market had become by 2006. In October of that year, the author attended a directors' retreat at a Rocky Mountain bed and breakfast inn operated by a former California real estate property manager. Asked why he had moved to Colorado and bought the business in April 2006, he answered that he had witnessed three business cycles in California real estate and was convinced the market would collapse soon. Liquidation of his and his wife's California real estate investments enabled them to buy the bed and breakfast free and clear. It was, in short, their hideout in the mountains from which they intended to view what they were convinced would be a real estate bust of epic proportions.

Metrics reported by the financial press, like the volume of loan originations, also suggested the market could not continue to grow apace for much longer. Evidence mounted that debtors could not weather a significant interest rate shock, fraud was rampant, and debtors with poor credit were demonstrably unlikely to repay their loans even if they had the best intentions. Financial institutions' regulators, such as Pennsylvania's Bill Schenck, were cracking down on payday lenders and their ilk, recognizing the economic damage that flowed from high interest rate lending to marginal consumer borrowers. Yet national market participants plunged ahead, seduced by overconfidence in their own creations.

### Innovation and Regulation — Necessary Partners

Press reports of the gridlock that gripped the market in early spring

offered intriguing glimpses of chastened bankers. Said one failed hedge fund's manager, "it is humbling to realize how much bigger than me the market is." Offered another, "Regulation needs to catch up with innovation." American historian Richard Hofstadter wrote in the 1950s about the farm labor movement, saying farmers are capitalists during boom times and socialists during lean times. Can it be that bankers, lawyers, and farmers have this in common?

Congress created the Federal Reserve system ("the Fed") following the Panic of 1907 when only the intervention of J.P. Morgan saved the national economy from worse calamity. Bankers and legislators alike recognized that the scale of the industrial economy then emerging required a central bank because no private institution was large enough to guarantee the orderly operation of the financial markets. Depression era legislation, including the Glass Steagall Act, overlaid further constraints for essentially similar reasons.

The experiment in deregulation that began with the Garn-St. Germain Depository Institutions Act of 1982 flowed from a recognition that the constraints that had once supported financial markets and the national economy now hindered rather than promoted the general welfare. Regulatory strictures failed to account for technological innovation, globalization and the rise of non-industrial sectors of the economy. Full flowering of the trend toward deregulation came in the form of the Gramm-Leach-Bliley Act of 1999, with its emphasis on functional regulation, and promotion of technology-based financial services.

The recent financial crisis is the third one to result from the unintended consequences of deregulation and innovation in financial markets. The Thrift Crisis of the late 1980s resulted from thrift institutions' inability to adapt to deregulation of interest rates on loans and deposits. Hungry for high-yield investments to balance the deposit yields they had to pay, thrifts became a piggy bank for Drexel Burnham Lambert's junk bond-financed takeovers — an innovation that could not have occurred without the ready source of funds the post-deregulation thrifts represented.

In an altogether different way, financial innovation by Long-Term Capital Management's ("LTCM") brainy mathematicians threatened to bring the U.S. financial market to its knees in 1999. As with the recent mortgage financing crisis, success begat imitation, and imitation begat secu-

rities and currency bets that were simply too numerous and too large to be unwound in an orderly fashion without Federal Reserve intervention. LTCM's investors decried the orderly liquidation of their firm no less than Bear's stockholders. Yet the risk to the financial system of letting nature take its course was simply too great in the Fed's view to allow for any other outcome.

## Foundations Reconsidered

Post-mortem engineering analysis of the dam failure in Austin, Pennsylvania indicated that the dam was safe against a bearing capacity failure. In other words, it could withstand the pressure of the impounded water against the dam's face. The dam failed because it slid on its rock foundation, the sandstone in which the concrete structure was anchored having separated from a layer of shale beneath the sandstone. The structure's designer had specified a deeper foundation, but the contractor skimped on that and perhaps other design requirements.

The sliding foundation of financial services regulation is not a matter of corners cut. Rather it is a byproduct of market innovations and the changing and expanding roles of institutions in the market. The denouement of the Bear Stearns story reflects this reality. The bank's demise was a consequence of mismanagement of risks associated with mortgage-backed securities. The Fed's delivery of Bear into the hands of JP Morgan Chase required the Fed to provide an unprecedented measure of financial assistance. Meanwhile, the OCC had to waive limitations on concentration of investments that otherwise would have prevented Morgan from making the acquisition.

All of this maneuvering suggests that Congress must get serious about consolidating the overlapping agencies that regulate financial institutions. Coordinated regulation — such as joint rulemaking, examinations, and enforcement — is not enough. The underlying fundamentals of the industry have so changed that a unitary regulatory scheme is called for — one that creates greater efficiency, saves money, and offers institutions that are subject to it a single point of contact.

Beyond organizational structure, a revised regulatory framework must be able to accommodate — and appropriately regulate — technology-based

changes in financial services. The recent history of financial regulators' dealings with technology-based innovation in financial services is less than impressive. Consider some examples.

Securitization was widely viewed within the community of bank regulators as a useful way to mitigate banks' risks. By aggregating and selling assets into securitizations, the thinking went, banks could recycle their capital and reduce the risks of holding large asset positions on their balance sheets. The reality has been different. After regulators awakened in 2000 to the risks of banks' retaining the residual pieces of securitization transactions, federal regulators via an administrative rule abruptly required dollar for dollar reserves against the residual interests. At the time the rule was promulgated, the author was advising a bank then experiencing a significant liquidity crisis. The rule was not only vaguely written, if adopted as proposed it would have put that institution and about 20 others out of business. Meetings with the rule's authors led to the implementation of a less onerous standard that addressed regulators' and institutions' concerns about residual interests in securitization transactions.

In other cases, regulators' statutory authority has been insufficient to reach innovations that posed risk to the financial system. An early installment of this column chronicled the arrival of a new service, PayPal, then owned by a privately-held company named X-Com and now owned by eBay. The author suggested that PayPal was a bank in drag — it piggybacked on the banking system and mimicked FDIC insurance with a commercial insurance policy that purported to insure funds transferred by PayPal. Yet customer funds were commingled and depositors were offered none of the funds availability protections provided by FDIC-insured depository institutions. The author asked regulators why they had not sought to extend their regulatory franchise to PayPal. They responded that it was difficult to know what innovations would succeed and thereby warrant regulatory attention. They conceded they had been caught off guard by PayPal's sudden success.

The civil engineering analogy of dam, bridge, and highway construction offers a useful conceptual framework for how financial institutions regulation needs to be restructured in the era of technology-based financial services. Features that deserve to be emulated, or bolstered, in reordering financial services regulation include the following:

### *Comprehensive Planning*

Contrast the hodge-podge of roads and bridges that is Boston with the approach to road and bridge construction in Florida. Since 1992, the Florida Department of Highways has applied a master-plan approach to anticipate demand. The result is that roads and highways are constructed before adjacent property is developed. Tomorrow's world is ordered today, reducing confusion and delay.

### *Uniform Design and Construction Standards*

The Interstate Highway System illustrates the value (and safety, with occasional exceptions) of uniform design and construction. The system supports billions of automotive transactions every year.

### *Materials Testing*

Steel for highways and bridges has been tested and certified for its load bearing and metallurgical properties for decades. Ditto every other important building material — concrete, asphalt, stone ballast and so forth. Why not subject complex, mathematically-based financial innovations to advance testing in the same way?

### *Redesigned Safety and Soundness Inspection*

In the wake of the collapse of the I-35 bridge in Minneapolis last year, most states redoubled their efforts to test the safety of bridges and highways. The head of Pennsylvania's transportation department announced, however, that his department would not release its findings. Public outcry ensued and the Governor immediately reversed the decision. Why should not the results of bank safety and soundness examinations, including CAMELS ratings, be public information? The functional premise of the current system is that the public cannot handle the truth. Runs on weak banks will surely follow. Better to live in a father-knows-best world, where regulators discipline underperforming institutions in secret and quietly close those that are too far gone to survive. The trouble is that the financial system today is so large and

so complex that no one government agency can know all or solve all in real time — at least not as they are currently constituted. The effectiveness of a father-knows-best system depends on controlling the nature and quantity of information made available to the public about the institutions being regulated. In a world of electronic markets and Internet-speed transmission of market data, such a system is obsolete.

Many recent regulatory initiatives prompted by the influence of technology on financial services — such as those requiring examination of information technology infrastructure — amount to add-ons to existing safety and soundness examination protocols. Banks are tasked with assuring the integrity of processes and procedures used by their IT contractors and subcontractors. What is needed is a complete overhaul. Today's reality is that the risk of loss begins with product design and continues through production, marketing and distribution. What is needed is a bottom-up, not top down, regulatory view. Safety and soundness examinations need to begin with an examination of the process by which financial institutions determine what products to make and how they are produced. Algorithms for technology-based products should be tested by regulators before and during product development and deployment rather than in regression analyses after institutions fail. One need not adopt the product approval process of the pharmaceutical industry — where products cannot be marketed at all without prior regulatory approval. Yet a simultaneous review and revision process could be of enormous benefit. Creation of a repository of best practices data and the availability of independent assessments from seasoned professionals are called for. The civil engineering knowledge base possessed by the Army Corps of Engineers is a useful prototype. Reformulation of bank safety and soundness examinations on these principles could produce significant advances that would benefit all market participants.

### *Good Conduct Rewards*

Some observers have written that the recent market turmoil has occurred despite initial deployment of Basel II's risk-based capital standards. They reason that because recent events have revealed flaws in banks' risk measurement and management systems, a Basel II-like system of risk based

capital cannot succeed. They are dead wrong. The lesson of recent market failures is that a Basel II system of risk-based capital standards is all the more necessary in a technology-based financial services economy. Structure and calibration of the model require additional work. The basic impulse, however, is the correct one. Those institutions that can demonstrate empirically over an extended period of time that their risk management systems are superior deserve to have their performance rewarded, such as by carrying lower capital levels.

### *Bad Conduct Penalties*

In recent years, regulators have been much faster to draw and fire when it comes to imposing penalties for bad behavior within financial institutions. Some would say too fast. In the author's view, what is needed is a double edged sword penalty system — one that affords regulators broad discretion to penalize miscreants, but that extracts equal justice if abused by overzealous regulators. When Eliot Spitzer first burst on the scene, a senior OCC official commented that he had identified a new risk category, "Eliot Spitzer Risk." Asked what that was, he replied, "the risk of being shown up by an aggressive state regulator." There is no escaping the politics of regulatory enforcement. The antidote to overzealous prosecution is an enforcement system that creates incentives for fair play by all concerned and that punishes those who abuse their power or influence, be they the regulators or the regulated.

### Conclusion

Technology is a force multiplier, in financial services as in civil engineering. As the nation's nearly 30 year experiment in deregulation has unfolded, financial engineers have built increasingly complex structures to impound and channel greater and greater volumes of products being brought to market and distributed among buyers and resellers. Like logs gathered on a mill pond, awaiting their turn in the saw mill below, mortgages or other assets are raw materials as they enter the financial services production process. Unlike timber, however, financial raw materials embody

the life plans, business plans, hopes and fears of the consumers and businesses from which they emanate. When the dam that holds the mill pond breaks, there is no escaping flood, fire, and destruction. As we live through the latest crisis in the financial services economy, it is essential that we not lose the resolve to minimize the number and scale of future disasters. Only by absorbing the lessons of recent crises, and constructing a revamped regulatory framework for our technology-based financial services economy that anticipates future developments and manages them appropriately, can we avoid repeating the unhappy experience of the present moment.

**Debt Collector's Practice Of Bringing Lawsuits To Collect Debts Without Any Intention Or Ability To Obtain Admissible Evidence To Prove The Existence Or The Amount Of Such Debts At Trial Is A Deceptive Practice Prohibited By The Fair Debt Collection Practices Act. *Mello v. Great Seneca Financial Corp.*, 526 F. Supp. 2d 1020 (C.D. Cal. 2007).**

A consumer, Mr. Mello, brought a lawsuit against Great Seneca Financial Corp., ("GSFC") alleging that GSFC brought a frivolous lawsuit against him to collect a debt that was barred by the statute of limitations, and that he was harassed and abused by GSFG. Mello alleged a violation of the Fair Debt Collection

Practices Act ("FDCPA") because GSFG filed a lawsuit knowing that the evidence in its possession or any evidence that it might obtain will be insufficient as a matter of law to prove a case at trial.

Although some courts have held that the filing of a lawsuit prior to obtaining admissible evidence of validity of the debt is not a violation of the FDCPA, the court held that the GSFG's business model constitutes a violation of the FDCPA. The GSFG business model consists of purchasing defaulted debt for pennies on the dollar to sue the debtors, without obtaining any evidence regarding the validity of the debt, in the expectation of obtaining a default judgment against the debtor, and then collecting the judgment.

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GSFG engaged in a pattern and practice of initiating debt collection litigation without ever obtaining or intending to obtain any evidence of the alleged debts, with an improper motive to collect judgment on debts that it knew it would be unable to prove at trial. The court held that this absence of any intention or ability to obtain admissible evidence of the alleged debts constitutes a violation of the FDCPA.

**Fair Credit Reporting Act Does Not Permit A Private Litigant To Seek Injunctive Relief Against A Credit Reporting Agency. *Smith v. Equifax Information Services, LLC, et al.*, 522 F. Supp. 2d 822 (E.D. Tex. 2007).**

A thief stole the identity of Vilma Smith (“Smith”) and used her personal information and identity to apply for extensions of credit and to enter into multiple leases. As a result, Smith was thereafter unable to obtain credit or loans due to allegedly false credit reports generated by national credit reporting agencies, including CSC Credit Services, Inc. (“CSC”). Smith brought suit under the Fair Credit Reporting Act (“FCRA”) against CSC and the

other credit reporting agencies and requested the court to order CSC to reinvestigate and correct Smith’s credit reports and credit history. CSC moved to dismiss Smith’s request for injunctive relief, arguing that the FCRA did not allow private plaintiffs to seek injunctive relief against credit reporting agencies. Smith, on the other hand, argued that she was permitted to seek injunctive relief under FCRA and, even if she was not, that Texas law allowed a private plaintiff to seek injunctive relief in a situation such as this.

The court agreed with CSC and held that a private litigant may not seek injunctive relief against a consumer reporting agency under FCRA. In support of its ruling, the court stated that FCRA affirmatively granted power to the Federal Trade Commission (“FTC”) to pursue injunctive relief against consumer reporting agencies, but did not include a similar grant of power for private litigants. That fact, coupled with FCRA’s grant of power to private litigants to obtain damages and other relief, convinced the court that Congress intended the power to obtain injunctive relief to lie solely with the FTC.

Regarding Smith’s claim that

state law entitled her to seek injunctive relief against CSC, the court determined that any state law claim was pre-empted by FCRA. The court noted that FCRA preempts state law to the extent that those laws are inconsistent with FCRA. Since the court had already determined that Congress intended that only the FTC should be able to seek injunctive relief against credit reporting agencies, any state law allowing a private litigant to seek such injunctive relief conflicted with and, therefore, was trumped by FCRA. Thus, the court dismissed Smith's request for injunctive relief against CSC.

**Bank Did Not Substantially Contribute To Employer's Loss When Employee Opened Account At The Bank And Deposited Checks Stolen From Employer. *Auto-Owners Insurance Co. v. Bank One*, 879 N.E.2d 1086 (Ind. 2008)**

Kenneth Wulf ("Wulf"), an employee of Auto-Owners Insurance Company ("Auto-Owners") stole more than \$500,000 from Auto-Owners by depositing checks payable to Auto-Owners into a personal account he opened at Bank

One (the "Bank"). Wulf had access to the checks because, as a resident adjuster at Auto-Owners, one of his responsibilities was to handle the checks for his files that Auto-Owners received for subrogation and salvage. Even though it was Auto-Owners' stated policy for all files to be reviewed by a manager every six months, Wulf's fraud was not discovered by Auto-Owners until eight years after it began.

Upon discovering Wulf's fraud, Auto-Owners brought suit against the Bank for violating Indiana Commercial Code § 405(b), which states that any bank which pays or takes a payable instrument from an employee who fraudulently endorsed the payable instrument from an employer must use ordinary care in paying or taking the instrument and is liable for any loss to the employer if the failure to use ordinary care substantially contributes to the loss.

In accordance with this statute, Auto-Owners alleged that the Bank failed to exercise ordinary care in its opening of Wulf's account and that this failure substantially contributed to its losses thereby making the Bank liable for its losses. To the contrary, the Bank denied that it had failed to exercise ordinary care at any time and filed a summary judgment

motion. The trial court granted the Bank's summary judgment motion and the court of appeals affirmed. The case was then transferred to the Indiana Supreme Court on two questions: (1) whether the Bank was subject to an ordinary care requirement for its actions in opening an account for Wulf, and if so, (2) whether the Bank's failure to exercise ordinary care substantially contributed to Auto-Owners' losses.

First, the court examined whether the Bank exercised ordinary care. The court looked at the language of § 405(b) and determined that it only requires ordinary care from a bank in the paying or taking of an instrument, not in the opening of an account for a new customer. The allegation here was that the Bank failed to exercise ordinary care when it allowed Wulf to open an account in Auto-Owners' name, not that the Bank failed to exercise ordinary care in the paying or taking of Wulf's checks. The court noted that in the absence of a bank's negligence, § 405 shifts the responsibility for monitoring an employee's fraudulent acts away from a bank and onto the employer because an employer is in a better position than a bank to supervise its employees.

Next, the court stated that, even

if the Bank did not demonstrate ordinary care in its acceptance of checks from Wulf, Auto-Owners still must show that the lack of ordinary care substantially contributed to its losses. The court noted that the test for "substantially contributes" is less stringent than a "direct and proximate cause" test. The court set forth the test for "substantially contributes" as: (1) whether the opening of the bank accounts was a contributing factor to Auto-Owners' loss and (2) whether the opening of the bank account was a substantial factor in bringing the loss about. The court stated that aside from the bank's possible failure to follow its procedure in opening the bank account, the Bank followed its required protocol in depositing Wulf's checks. Further, the court stated that even if it assumed that the Bank's conduct in opening the account was a contributing factor to Auto-Owners' loss, the Bank's conduct was not a substantial factor in bringing that loss about as required by second part of the test. Rather, the court implied that Auto-Owners' loss was attributable to its own lack of diligence in regulating its files and its employees, as evidenced by the fact that it did not discover Wulf's fraud for eight years. Accordingly,

the court upheld the trial court's and the court of appeals' grant of summary judgment in favor of the Bank.

**The One-Year Statute Of Limitations Under The Truth-In-Lending Act Runs From The Date That The Allegedly Improper Fees Were First Disclosed, Not When They Were First Charged And Paid. *McNaney v. Astoria Financial Corp.*, 2008 WL 222524 (E.D.N.Y. 2008)**

Plaintiffs brought this class action against various financial institutions alleging, among other things, violations of the Truth in Lending Act ("TILA"). The court dismissed the named plaintiffs on statute-of-limitation grounds. Plaintiffs moved to reconsider, arguing that the court applied the wrong limitations period because it mischaracterized their Home Equity Line of Credit ("HELOC") as a "closed-end" line of credit under TILA instead of an "open-end" line of credit.

Although the court agreed with the plaintiffs that their HELOC was an "open-end" line of credit, it disagreed that that mischaracterization resulted in a timely lawsuit. TILA provides that "any action under this

section may be brought within one year from the date of the occurrence of the violation. 15 U.S.C. § 1640(c). Plaintiffs assert that the correct standard was the discovery rule, which meant that the limitation period began to toll when the Russos discovered the TILA violation. The district court, in affirming the lower court's order, applied the broadly accepted standard of calculating the limitations period for "open-end" lines of credit as the date the first finance charge was imposed. The district court noted that even applying the discovery rule as suggested by plaintiffs, the claim would still be time-barred, as calculation of the time period began when the Russos signed the documentation for the HELOC because the fees were disclosed at such time and not when they paid the fees.

**Under The Litigation Privilege Admissible To Prove Violations Of California's Rosenthal Fair Debt Collection Practices Act. *Butler v. Resurgence Financial, LLC*, 521 F.Supp.2d 1093 (C.D. Cal. 2007)**

Plaintiff Sheldon Butler ("Plaintiff") filed two claims against Resurgence Financial, LLC, ("Defendant") for alleged violations

of: (1) the Fair Debt Collection Practices Act; and (2) the Rosenthal Fair Debt Collection Practices Act (“Rosenthal Act”). Defendant moved for judgment on the pleadings only as to Plaintiff’s Rosenthal Act claim, arguing that it is barred by California’s litigation privilege.

Under California Civil Code § 47(b), a publication or broadcast is privileged if it is made “in any (1) legislative proceeding, (2) judicial proceeding, or (3) in any other official proceeding.” In the instant case, Plaintiff alleges that, during a consumer debt collection action, Defendant made misrepresentations in the complaint, false statements in sworn discovery responses, false statements as to the authenticity of documents, and false allegations that Defendant was entitled to attorneys’ fees. Plaintiff alleged that these misrepresentations constituted a violation of the Rosenthal Act, even though they were statements that would ordinarily be protected by the litigation privilege.

Nonetheless, the court denied Defendant’s motion for a judgment on the pleadings, holding that California’s litigation privilege did not bar consumer’s Rosenthal Act claim and that the litigation privilege does not apply to provisions of the

Rosenthal Act. In making its determination, the court relied on the reasoning in *Oei v. N. Star Capital Acquisitions, LLC*, 486 F.Supp.2d 1089 (C.D. Cal. 2006). The *Oei* court reasoned that the protections of the Rosenthal Act would be rendered meaningless if the privilege applied. Specifically, the California Legislature has enacted regulations regarding collection practices designed to “ensure that debt collectors and debtors exercise their responsibilities to one another with fairness, honesty and due regard for the rights of the other.” *Id.* The court concluded that if the litigation privilege were allowed to trump the protections of the Rosenthal Act, the legislature’s purpose could not be effectuated.

**A Flood-Determination Company Retained By The Lender To Perform A Flood-Zone Determination On A Borrower’s Property Does Not Owe A Duty To The Borrower, And Therefore The Borrower Cannot State A Claim For Negligence Against The Company. *Audler v. CBC Innovis, Inc.*, 2008 WL 509323 (C.A. 5 (LA.)).**

Audler’s home was flooded by

hurricane Katrina and he did not have flood insurance. Audler sued CBC Innovis, Inc., ("CBC") and other defendants alleging that he failed to obtain flood insurance because CBC certified that his home was not located within a flood hazard zone.

The National Flood Insurance Act of 1968 established the National Flood Insurance Program to offer reasonably priced flood insurance to people living in flood-prone zones. In 1973, Congress enacted the Flood Disaster Protection Act, which amended the National Flood Insurance Act to require lenders to check whether a property which secures their loan is situated in a flood hazard zone, and if so, to ensure that the flood insurance for the property is obtained. The lender has a duty to investigate and to notify the borrower if the property is subject to the flood hazard. CBC was retained by Audler's lender to determine whether the property was

located in a flood hazard zone in connection with a refinancing of the property. CBC certified to the lender that the property was not within a flood hazard zone and a copy of this certification was given to Audler.

Audler made multiple claims against CBC, all under Louisiana law, including negligence and negligent misrepresentation, failure to warn, and detrimental reliance. The court dismissed Audler's claims on the ground that CBC did not owe a duty to Audler. CBC did not owe a duty to Audler because Audler was not the intended beneficiary of CBC's flood zone determination. Audler was not the intended beneficiary of the flood zone determination because the primary purpose of the requirement for flood zone determination was to reduce the financial risk to the lender and the federal government of uninsured homes located in flood zones, not to assist individual borrowers damaged by flooding.

THE BANKING LAW JOURNAL

VOLUME 125 NUMBER 6

JUNE 2008