Community Bank Failures and the D&O Marketplace

By Kevin Rankin, CNA Insurance

Until recently, the community bank insurance market has been a rather tranquil niche for most insurance carriers. Many community banks, especially those on the West Coast, displayed the coveted underwriting metrics (solid asset quality, high capital ratios, and consistent profits, etc.) that justified carriers competing aggressively for their business. Indeed, community banks became accustomed to competitive renewals, broad coverage enhancements, multi-year policies, and relatively low premiums.

How quickly things have changed. With the onset of the recession, those once solid underwriting metrics deteriorated steadily for many community banks, especially for banks heavily exposed to residential real estate and development. According to Zillow.com, in Las Vegas “underwater” capital of the country, with 2 out of every 3 mortgage holders owing more on their property than it is appraised to be worth. Other cities with high percentages of underwater mortgages are Stockton, Modesto, Vallejo, and Merced, California; Reno, Nevada, and Phoenix, Arizona. [1)] In July, Foresight Analytics, a California-based research group, announced that 371 banks nationwide are now considered to be undercapitalized and vulnerable to closure by the regulatory agencies. [2)] Last year, only 1 bank in Washington State was on that list; this year there are 18. Today more than 30% of the construction loans in metro Seattle are delinquent or in default.

As has been widely reported, the FDIC has been proactively closing distressed banks, with announcements of multiple failures coming almost weekly. In 2008, the FDIC closed 25 banks, including the much publicized closures of large regionals like IndyMac Bank and Washington Mutual. This year the FDIC’s pace has quickened. Through August 14, 2009, the regulators have closed 77 banks. Most have been smaller community banks (of the 77 failures, 66 had assets under $1B). [3)] Georgia and Illinois lead the nation with 16 and 12 closures respectively; however, the closures have been widespread -- the FDIC has closed banks in 24 states. [4)]

The regulators are not expected to back off from closing community banks any time soon. The Federal Reserve and the Office of the Comptroller of the Currency, the two primary community bank regulators, have issued 285 Memorandums of Understanding so far in 2009 and are on track to issue 600 for the year, compared to 399 last year. [5)] Unemployment nationally has been increasing and home prices in many parts of the country have yet to stabilize. Most of the banks that have failed to date have been burdened with soured investment or residential loan portfolios. However, the deepening recession could soon jeopardize commercial real estate portfolios as well. By the end of 2010, over 900 small community banks could collectively be exposed to $100B in commercial real estate losses. [6)]

The bank failures have resulted in increased litigation -- from both private shareholders and the regulators. Of the 25 banks that were closed in 2008, 6 are already involved in class action, derivative, or individual litigation. [7)] At one small failed bank in Illinois, for example, 2 former directors and the president have been sued by a shareholder who has alleged their self-interested transactions and detrimental banking practices caused the bank to fail and fellow shareholders to suffer losses. [8)]

An early-August post on BusinessInsurance.com entitled “FDIC Signals Move to Collect on Banks’ D&O Cover” noted that there are indications the regulators could re-open their savings & loan crisis playbooks to sue failed bank board members and executives, thereby activating the bank’s Directors’ and Officers’ insurance policies. [9)] When a bank fails, the FDIC often becomes the primary shareholder and could sue the bank’s directors and officers for gross negligence or breach of fiduciary duty. [10)]

Insurance carriers have responded quickly to these substantial changes in the community banking space. According to analysis by Aon Financial Services, pricing for Directors and Officers insurance in the S&P Financials sector skyrocketed 50% in 4Q08.[11)] Some carriers are not writing community banks in certain geographic markets or with particular financial metrics. Other carriers are enforcing the mid-term "material change of risk" cancellation clauses buried in their forms, thereby giving the bank only 90 days notice to find new coverage. Lastly, some carriers have added a "regulatory exclusion" to their forms, which would prohibit claims brought by regulatory agencies from coverage. The "regulatory exclusion" used to be common practice during the savings and loan crisis – when, according to a 1995 article, 50-75% of community banks' D&O insurance policies had such exclusions.[12)]

In such a rapidly changing market, it is more important than ever for directors to be informed of and actively involved in their bank's D&O policy. No insurance policy can provide blanket protection; but in these uncertain times, it is crucial to have your insurance broker review your overall insurance program and determine if there are any significant gaps in coverage. If the policy is inadequate, the bank could be putting its directors' personal assets at risk.

1) "Economic Update – Smaller Banks Face CRE Woes", *Real Talk with Commercial Property News*, (May 7, 2009)
2) "More Washington State Banks Hit by Bad Loans", *KUOW News*, (July 6, 2009)
3) "Web Notes and Updates", *The D&O Diary*, (August 3, 2009)
4) "Bank Failures by the Numbers: A Look at Where and Why Institutions are Failing in 2009", *BankInfosecurity.com*, (August 17, 2009)
5) "Regulators are Getting Tougher on Banks", *Wall Street Journal,* (July 31, 2009)
6) "Local Banks Face Big Losses", Wall *Street Journal,* (May 19, 2009)
7) "The Growing Number of Bank Failures and the D&O Insurance Marketplace", *OakBridge Insights*, (Vol. IV Issue Three May/June 2009)
8) "Bank Failures Surge, D&O Claims Emerge", *The D&O Diary*, (June 29, 2009)
9) "FDIC Signals Move to Collect on Banks' D&O Cover", *BusinessInsurance.com,* (August 9, 2009)
10) "FDIC May Sue Bank Officers, Directors", *Atlanta Business Chronicle,* (May 22, 2009)
11) "Quarterly D&O Pricing Index Fourth Quarter 2008", Aon Risk Services (Quarterly)
12) "D&O Liability Policies – Regulatory Exclusion", Latham & Watkins*, Client Alert*, (July 21, 2008)

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