Community Banks
D&O Insurance in the Current Market

By Kevin Rankin, CNA Insurance

Yogi Berra once remarked, "Why buy good luggage? You only use it when you travel." [1] While the former Yankee catcher could have been describing his frugal preparations for spring training, his metaphor could also describe the once price-driven thought-process of the buyer of community bank insurance. However, with shareholder claims on the rise and bank failures expected to be elevated in 2010, [2] the coverage that insures your bank's most senior people should no longer be purchased as a commodity.

D&O Insurance Overview

Generally Directors and Officers insurance is structured in three layers: Side A coverage insures the Directors and Officers for claims against them for wrongful acts. Side A is triggered when the bank can not, or will not, indemnify its D&Os. Side B coverage is insurance for when the bank does indemnify its D&Os. And Side C coverage (or Entity Coverage) protects the corporation.

Without D&O insurance, litigation expenses (and any damages awarded) would be the responsibility of either the institution or, if no indemnification agreement is in place, the Directors and Officers personally. Banks can expect that because of the potential for personal liability, Directors and Officers will scrutinize the bank's D&O policy. If the coverage is nonexistent or weak, current or prospective Directors may decide the personal risk of the position is too great. Institutions may be left handicapped in their efforts to attract and keep top talent and depositors.

The Changing D&O Insurance Landscape

Until recently, the community banking insurance market was considered "soft". Many national carriers competed aggressively for the business, offering broad coverage enhancements, multi-year policy terms, and low premiums for most accounts. To the carriers, community banks were good risks – claims were low, so the cost of their capital was cheap. To the insurance buyer, the decision of which D&O product to purchase was often made simply on price, since claims were few.

The market "hardened" considerably in 2009, mostly due to deteriorated underwriting metrics. Currently, it is the FDIC's closure of 140 community banks and the wave of expected litigation that is driving the market. When a bank is closed by the regulators, the FDIC becomes the primary shareholder of the institution, and it retains the right to sue the D&Os for "gross negligence" that may have contributed to the failure. [3] While the FDIC has not yet filed a suit, the regulators have begun preparing for litigations. According to FinCri Advisors, a respected financial services website, the FDIC has sent claim letters to former directors at failed banks in Florida, California, Illinois, Texas, and Georgia. [4] According to a lawyer quoted in the article, the trigger for the demand letter was the expiration date of the D&O insurance. Further, according to industry experts cited in an Atlanta Business Chronicle article, demand letters "likely have been filed with insurers by all 30 banks that have failed in Georgia since August 2008." [5]

With the FDIC acting to preserve its right to file suit against D&Os, the community bank insurance market is not expected to soften again soon. In fact, it most likely will harden more due to the impact of impending commercial real estate losses. According to the Congressional Oversight Panel of the TARP program, between 2010 and 2014, about \$1.4T of CRE loans will come due, and nearly half are currently "underwater". Community banks could bear the greatest burden – the report found that nearly 3,000 banks have concentrations in CRE, including 2,115 with assets of \$100M - \$1B. [6] The FDIC has nearly doubled its budget for 2010 and it is looking to add 1,600 more personnel (about 950 of which will handle failed banks). [7] One investor in community banks predicts 500-800 banks will fail due to upcoming losses in commercial loans. [8]

Tips for Insurance Renewal in a Hard Market

During these unsettled times, there are a few important things to keep in mind when preparing for your 2010 D&O insurance renewal in a hard market:

- Develop open lines of communication with your carrier: In today's hard market, carriers closely scrutinize risks when offering or renewing coverage. When seeking a renewal or a new policy, an effective way to ensure that a carrier understands and is comfortable with a bank's risk is to involve management in the discussion. For example, in my experience assessing risk as an underwriter for a national carrier, a conference call with management is often the most productive tool for learning the "story" and getting comfortable with a risk. Banks with regulatory or asset quality issues need to be especially forthright about providing background on their institution, the causes of their financial issues, and their progress working through the regulatory order. Banks that demonstrate soundness will most likely be able to put a more comprehensive program in place.
- Use an insurance broker or consultant that is familiar with community banking products: D&O insurance policies have become increasingly complex: Most board members do not have the time or the expertise to devote to the insurance renewal. Many community banks have gone a step farther by having a lawyer with a proven track record review their D&O polices for possible gaps in coverage.
- Be mindful of restrictive provisions that are creeping into insurance contracts: According to a respected financial services website, several bank D&O carriers, including those endorsed by state and national banking associations, have adapted language that allows them to abruptly cancel contract mid-term by citing material changes of risk such as increased non-performing loans, high levels of commercial loans, or newly issued regulatory orders.[9)] It is also being reported that some carriers are not allowing banks the option of purchasing extended reporting coverage, or "tail" coverage, even if the bank is being non-renewed.[10)]
- Consider claims handling: In the end, the product the bank is buying is claims handling. D&O claims are often large, so it important to know the insurance carrier with which the bank is contracting has not only the funds, but also the expertise to properly handle a significant claim.
- Lastly, now is the time to add more insurance, not less: For extra piece of mind, consider adding additional Side A D&O coverage to your existing policy.

1 Yogi Berra Quotes, *Thinkexist.com*
2 "FDIC Geared up for Busy Year of Bank Failures", *News.yahoo.com*, January 20, 2010
3 "Litigation Wave May Hit Failed Banks", Atlanta Business Chronicle, January 8, 2010
4 "Failed Banks: Will the FDIC's Next Steps Include Litigation", *The D&O Diary*, January 11, 2010
5 "Litigation Wave May Hit Failed Banks", *Atlanta Business Chronicle*, January 8, 2010
6 "TARP Watchdog Says Commercial Real Estate Loans Pose Danger," *BusinessWeek.com*, February 11, 2010
7 "Update: FDIC Sees More Banks Reaching Risky Status in 2010", *Dow Jones Newswires*, December 12, 2009
8 "Danger Ahead for Small Banks", *Portfolio.com*, February 11, 2010
9 "Your D&O Insurer Might Be Scouring Your Call Report Looking to Cancel Coverage:", *FinCriAdvisor.com*, January 24, 2010
10 "Can Insurers Really Just Cancel Bank D&O Insurance", *The D&O Diary*, January 27, 2010

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