CLIENT ADVISORY

Regulatory Impact on D&O Insurance Market for Community Banks

While the overall health of most of the country's 6,891 community banks improved during 2013, the marketplace for Directors and Officers (D&O) insurance has yet to fully heal from the recent economic downturn. The FDIC, banking regulators and legislators have focused their attention on the banking industry, causing a multifaceted disruption to the insurance market. Many obstacles continue to put pressure on the banking industry and insurance marketplace for directors and officers, including sustained FDIC suits against bank executives, intensified regulatory burden from Basel III, Dodd-Frank and other financial reform legislation.

FDIC Actions Against Directors and Officers

Since the beginning of 2007, 492 financial institutions have failed. The FDIC filed 84 D&O lawsuits between 2010 and 2013, including 40 in 2013 alone. This does not include instances where settlement agreements were reached with bank executives before a formal lawsuit was filed. It is estimated that 34% of failed institutions faced FDIC claims against their directors and officers.[1]

The D&O insurance market continues to feel the effect of FDIC-related claims. Those carriers who had a significant number of failed institutions on their books have had to take precautionary actions in their underwriting to address these issues, including rate and retention increases, addition of regulatory exclusion endorsements and non-renewal of certain accounts.

"The carriers that were able to navigate the crisis without too much damage and those that were not in the marketplace at the time are in a great place," said Michael Whitbeck, president of Protx Risk Management, an MGA specializing in professional liability for community banks. "Those groups can now aggressively go after all levels of business and do not need to worry about the past."

While the number of new entrants in the community bank insurance market has been limited, their impact has been felt. Banks without regulatory orders (Memorandum of Understanding – MOU, Consent Order, Cease & Desist Order – C&D) have more competition to write their D&O insurance, as a flight to quality among insurance carrier's increases. On the other end of the spectrum, banks under higher levels of regulatory scrutiny have less competition seeking their business and are seeing more restrictive terms and conditions for insurance coverage.

Basel III

When introduced in 2009, the Basel III regulation was meant to establish a comprehensive set of reform measures designed to expand the supervision of depository institutions. These guidelines were intended to improve the banking industry's response to economic stress and reduce the risk of systematic shocks. Under Basel III, banks are required to maintain proper leverage ratios and meet certain capital requirements. Many smaller banks have complained that the cost of compliance would have a significant impact on the bottom-line.

When the "Final Rule" was adopted by the Basel III committee in July 2013, key victories for community banks seemed to have been achieved: 1) Accumulated other comprehensive income (AOCI) was successfully removed from regulatory capital through an "opt out" provision; 2) Complex and burdensome risk weights on residential mortgages were scaled back and will remain unchanged; and 3) Trust Preferred Securities (TruPS) will not be phased out of regulatory capital as originally proposed and will continue to be grandfathered for certain banks.[2]

Even with these victories, some significant hurdles remain for community banks.

"While seemingly a good thing, the Basel III regulation may have the unintended effect of causing more M&A activity as smaller healthy banks will seek to merge rather than keep up with the costs to comply with the new rules and regulations," said Gina Juhnke, product manager for AmTrust North America's Financial Institutions Group. "The impact on the community bank D&O market will be significant over the course of the next five years as the potential insured base shrinks."

And we know from experience that a leading cause of D&O claims stem from M&A activity. Reports have shown that nearly every M&A transaction over the past three years involving public companies has led to a suit against the directors and officers of those companies, which impacts their D&O policy.

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[1] (Cherin, Galley, Richardson, & Schertler, 2014)
[2] (Cole & Kendrick, 2013)

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Because of Basel III, underwriters for community banks are scrutinizing capital levels to determine what is true and what is "maneuvering" and/or "smoke and mirrors." Banks will continue to have Troubled Asset Relief Program (TARP) funds, Small Business Lending Funds (SBLF), and TruPS monies which will artificially bolster their capital numbers. In addition, the game of shrinking their balance sheet to bolster capital is being used all throughout the country. The better underwriters will see this and will price the risk accordingly.

JOBS Act

When the JOBS Act (Jumpstart Our Business Startups) was signed into law in 2012, significant changes to the community bank industry occurred: 1) It made it possible for small banks to raise additional capital without having to register with the Securities and Exchange Commission (SEC); and 2) The deregistration threshold increased from 300 shareholders to 1,200.[3]

Under the new law, banks with fewer than 2,000 shareholders are not required to register with the SEC. Banks with shareholders under this threshold have easier access to capital sources without the paralyzing level of compliance costs that come with being a publicly traded bank. In the past, financial institutions that were near this threshold were reluctant to seek new capital due to the filing requirements with the SEC.

While they do not get away from it completely, the financial savings significantly impacts the bottom line. Banks that register under the Securities Exchange Act of 1934 spend in excess of $100,000 on legal fees and accounting costs just for the initial filings, and $50,000 or more annually on compliance costs thereafter.[4]

"The JOBS Act benefits banks that had between 500-1,200 shareholders and provides these banks the ability to deregister and avoid costly SEC registration requirements," said Mark Tomlinson, assistant vice president and community bank practice leader for CNA Insurance. "On one hand, this reduces exposure because these banks are now fully private. On the flip side, the question is how does a bank effectively communicate relevant information to broader and possibly less homogeneous group of investors – in theory this could create more exposure."

A number of bank holding companies chose to deregister after the JOBS Act was passed in 2012 due to the cost savings involved. Historically, deregistering with the SEC was seen as a red flag from the D&O underwriter's perspective. Due to the JOBS Act, some D&O underwriters may discount this action. When a bank deregisters, shareholders are impacted. Good underwriters are more diligent and seek to dig deeper in order to fully understand the rationale for this decision and securitize how current shareholders react. This is not a technical analysis, but an extra question or two by an underwriter may allow the carrier to reduce their chances of seeing a major D&O claim.

Dodd-Frank

The Dodd-Frank Act has been positioned to the public as financial reform that will tame Wall Street bankers. When the original legislation was drafted, many people in the industry thought a number of the provisions would not apply to smaller "Main Street" community institutions, which so far has not been the case.[5]

Critics of the legislation complain that Dodd-Frank just adds to the already overwhelming regulatory burden forced onto the community bank industry due to financial reform. Small banks across the country are now committing significant resources just to keep up with the new legislation. Compliance departments for these banks, which consisted of just one employee five years ago, are now staffed with multiple full-time employees and attorneys.

"Dodd-Frank is another regulatory burden placed on an industry that already has a lot of regulation so I can't point to this impacting the D&O market positively or negatively by itself," said Tomlinson. "The larger picture impact is that smaller banks are having trouble surviving due the fixed costs associated with complying with Dodd-Frank and every other regulation and collectively, the regulatory environment is a significant factor impacting the current wave of M&A activity."

From the underwriting perspective, the new rules and regulations that have been enacted in the past four years have placed a greater onus on the carrier to ensure that the bank is compliant, or at the very least, has a dedicated compliance team to keep up with the heightened regulation. As a result, more scrutiny is given with respect to the bank's management practices and the experience of their staff. If the management of a bank were to mishandle the regulations, it can lead to a regulatory investigation and possibly a shareholder claim, which would both impact the D&O policy.

FDIC Letter – October 10, 2013

On October 10, 2013, the FDIC sent a letter to its member banks regarding D&O insurance. The letter included two overriding messages: 1) Directors and officers should be well versed in their D&O insurance policies; and 2) The FDIC expressly prohibits any coverage grants that would be used to reimburse civil money penalties (CMPs).[6]

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[3] (Douglas, 2012)
[4] (Independent Community Bankers of America, 2011)
[5] (Bennetts, 2012)
[6] (Federal Deposit Insurance Corporation, 2013)

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The letter was a wake-up call to many who serve on the board of directors of community banks. In the past six months, directors and officers of banks have become more engaged in the insurance buying process.

Whitebeck suggests, "This letter put the nad've bank officer or director on notice. All too often in the past few years, I would see accounts come in where a basic analysis showed the lack of knowledge by both the bank and the bank's insurance agent."

The FDIC letter brought CMPs to the forefront of coverage issues bank directors and officers need to consider. Despite the fact that insurers have used the D&O policy as a vehicle to afford CMP coverage for nearly 20 years, the FDIC has now taken the position that this coverage extension is unacceptable, citing Part 359 of the FDIC Act, which states that a bank cannot indemnify its directors and officers for CMPs assessed against them or purchase CMP insurance coverage on their behalf.

The FDIC letter basically forewarns banks that they will face regulatory scrutiny if their D&O policy extends coverage in this manner. As a result of the FDIC's recent position, banks and their agents are seeking to fill this "gap" in coverage as insurers are trying to determine how to provide an alternative coverage solution. Creating coverage for something prohibited by the FDIC may point regulators to insurance companies, which is not a situation desired by the insurers. As a result, we may not see an insurance product that will satisfy the concerns of the buyers.

Conclusions

All signs point to the fact that the community bank industry and the D&O insurance marketplace are at a cross-roads. As bank executives determine how to navigate the complex web of new regulation, underwriters continue to deal with the failures of the past and new legislative hurdles facing the industry. Banking executives should consider whether their insurance advisors are knowledgeable and experienced in dealing with the specialized risk of financial institutions and can counsel them through the complex intricacies of a D&O insurance policy. AmWINS has brokers that are highly specialized in insurance for financial institutions that can assist with the placement of insurance for all sizes of banks.

This article was authored by Joe Catalano of AmWINS Brokerage of Illinois. Joe is a member of our Financial Services Practice and is available to answer questions about this article and the coverage implications.