

# Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

December 20, 2010

## D&O Red Flags

*What You Need to Know before You Negotiate Insurance*

Insurers are demanding more information and taking deeper looks into your financials than ever before. If you don't understand what information they're after, or how it could impact the underwriting, you could end up with higher premiums and a nest of new exceptions.

"The level of scrutiny and the detail [demanded of financial institutions] has increased significantly in the last 18 to 24 months," says Matt Sweeney, a CU practice leader with Lockton, Overland Park, Kan. "Insurers are asking deeper sets of questions and they've tightened tolerances [for risk], too."

Casting around for D&O insurance isn't as pacific as it used to be, Sweeney adds. Financial institutions may find themselves surprised, and not in a good way, by the intensity of the vetting process.

"Many banks don't understand what insurers are looking for," he says. "They don't understand the scrutiny they're now under. Maybe they've worked with the same insurer and just renewed year after year. Insurers used to look just

at capital ratios. They're looking at

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## FDIC Proposes Scorecard Assessment Methodology for Large Banks

*Smaller Banks Could Be Next*

According to its critics, the FDIC's radical new proposal to change assessment methodology overrates recent risk and gives examiners too much subjectivity. The methodology applies only to large banks, but if the agency likes how the methodology works, it could adapt it to smaller banks, experts say.

With the new method, the FDIC plans to set assessments with scorecards in place of the old risk categories and debt ratings. The agency intends for the scorecard method to be a more finely grained, forward-looking approach to risk – one the agency hopes will help cut down on DIF losses. In the method, examiners will tally a bank's scorecard using qualities the agency considers "readily available and statistically significant in predicting an institution's long-term performance" and some subjective elements, too.

Recent FDIC proposals, including this one, benefit community banks since they shift more of the assessment burden to larger banks, says Eric Fischer, a partner with Goodwin Proctor LLP in Boston.

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## Bridging the D&O Data Divide

*Can Stress Testing, Risk Management Data Help with Insurance Premiums?*

Ever since the recession hit, D&O insurance premiums have gone up and insurers' tolerance for risk has gone down. For troubled banks or banks perceived to be in trouble, finding affordable premiums or even just getting coverage can be tough. If you bring stress test results to an insurer, can you argue for lower premiums and better coverage? Some banks are betting they can.

When an insurance company vets a financial institution before offering coverage, it typically relies on the documentation the financial institution – or its external auditor – gives them. In short, Call Report data. And that's just not enough information, says Don Musso, an analyst at Fin Pro, Liberty Corner, N.J.

"Insurers just don't have a good handle on how to evaluate risk in

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Published weekly (48 times a year).  
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## Stress Testing

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financial institutions," he says. "They're relying on public data to determine risk parameters, since they don't have access to the CAMELS scores."

Musso thinks that the insurance industry recognizes this data gap – that, since the recession, it lost confidence in its ability to adequately assess risk, but hasn't found a way to get better analysis on its own. As a result, insurers have built that uncertainty into their premiums and risk tolerances. That's why premiums have come up so much the last year or two, he argues.

His solution: Provide insurers the data they need to give banks the lower premiums they may deserve. Musso has asked all his clients to let his firm prepare stress test and ERM data specifically for insurance negotiations. So far, three of his clients have taken him up on it.

"We're trying to show [insurers] the real risk to the institution," he says. "If an institution falls below certain benchmarks, then the insurers have every right to charge [high premiums]. But if the bank turns things around and can prove it, those premiums should be lower. There's got to be a way to give a break to troubled institutions if they meet certain criteria."

For financial institutions in good health, preparing stress test data for an insurer is probably overkill, says LaVonda Alleman, a senior account executive with insurance broker Lockton in Overland Park, Kan.

"Insurance carriers set their underwriting standards based on ratios using call report [data],"

she says. "They have clear guidelines and ratios they work off of. It's all pretty black and white. I don't know that they'd change their underwriting philosophy just because a stress test comes in. I just don't see them doing it."

John Wells, the CEO of ABA Insurance Services, Mayfield Heights, OH, agrees. "It's just one more piece of data," he says. "I don't want to be dismissive. We'll take all the data we can get. But if our own analysis gave us concern [about a bank], would this data tip us the other way? Probably not."

Wells admits, however, that his company may have more of an analytical bent than most other insurers of financial companies.

For a bank perceived to be troubled, that kind of data could make a difference. "The value proposition for this is with distressed banks," Alleman says. "An underwriter looking at a troubled bank may not offer terms or else it may protect itself with a battery of exclusions or a high premium. That troubled bank may be able to argue some of those premiums down or those exclusions away with stress test data that makes the bank's financials look better."

### Could Insurers Turn to Stress Testing?

So far, the insurance industry hasn't added stress testing data to its standard due diligence, but that could change, says Scott Uhl, a senior VP at EWI Risk Services, in Dallas, Tex. And if it does, the financial industry insurers could have a much richer view into your balance sheet, and the potential costs to insure it.

"The \$64,000 question is: Will

D&O insurers continue to rely on the financial institutions themselves to provide published financial information to avoid losses or will they seek new methodologies, such as independent stress testing models, to further bolster their underwriting due diligence?" asks Uhl. "This is a key issue to underwriters. They may simply continue to use disclosure provided by banks and outside auditors, as is historical practice, or they may begin independent stress testing in this post-credit crisis environment."

Forward-looking tools like stress testing could be very useful to insurers, who are constantly

on the look-out for signs of delinquency or impending bankruptcy, says Uhl. At the moment, the cost of running stress tests is prohibitive for insurers. But as more and more stress test solution providers enter the market, insurers might make for unlikely customers.

"What I don't know is if underwriters – and reinsurers – will go to this next level of independent financial analysis that these independent stress test vendors may offer, or if they will continue to rely on their usual and customary underwriting criteria which usually is always dependent on published and/or audited financials from the named insured," he says.

One potential outcome for stress testing in insurance underwriting: The industry could price itself out of the market. "Insurers go for a spread of risk," Uhl says. "If stress tests change the way insurers view the risk categorization [for financial institutions], they may become too conservative. At the end of the day, if insurance companies become too conservative with underwriting practices, that can unintentionally eliminate their market presence within a particular sector, such as banks and financial institutions. They may not write any business." ■

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much more now."

What insurers have found over the years, is that it only makes sense to track a handful of broad risk indicators, says Kevin LaCroix a partner with OakBridge Insurance Services, Morristown, N.J., and the publisher of the *D&O Diary* blog. There are plenty of risk indicators out there, he says, but most of them are only apparent in hindsight, and that's not useful for insurers.

"Over time, the industry has reduced the number of factors it tracks down to less than a half dozen," he says. "These are the ones that correlate consistently with risk over time. If they're present, it means greater risk."

Here are the four broad categories of risk that worry insurers, says Scott Uhl, a senior VP at EWI

Risk Services, in Dallas, Tex. These categories provide the basis for a compensable loss under any D&O policy, he adds.

1. Shareholder/Stakeholder Claims. "These are typically for allegations of fraud and/or negligence seeking recovery of investor losses," Uhl says;

2. Derivative Demand Claims. This involves the breach of duty where the corporation nominally brings the action against individual directors and officers seeking monetary recovery for corporate treasury;

3. Regulatory Claims. This is a defense expense in cases where the bank is taken to court by the FDIC, SEC, DOJ, State AG or other governing body; and

4. FDIC Depositor Insurance Fund (DIF) Claims. This risk is triggered when the FDIC files a claim, seeking recovery for FDIC insured funds due to the insol-

veny of a failed bank.

When vetting a financial institution – which involves assessing the institution's potential vulnerability to these four categories of

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## How To Prepare for Your Insurer Meeting

- Start early.
- If you use a broker, review the information they plan to send to insurers. "You need to know what's being sent," says Lockton's Matt Sweeney.
- Set face-to-face meetings with the insurer.
- And most importantly, put together a quality submission. "The details of the file the broker is reading is critical," says Sweeney. "Talk to the insurer – in person if you can manage it or else on the phone – and talk them through some of the publicly available information." ■

## D&O Red Flags

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risk – a D&O insurer typically looks for a number of red flags, Uhl adds. Here's the list of red flags and relevant factors Uhl looked for when he worked as an underwriter a few years ago:

**1. Regulatory Capital Requirements** – “Total Capital” (sum of Tier 1 and Tier 2 equal to at least 6% and 10% on deposit institutions total risk-weighted assets (varies by underwriter));

**2. Loan Portfolio Management (CRE & Residential)**

- a. Concentration by loan type or industry
- b. Securities Portfolio Management
- c. Macroeconomic issues (recession, slowdown, contagion, regional unemployment, etc.)
- d. Depreciation of assets and loan collateral impairment
- e. Underwriting practices & borrowing terms (adherence to and deviation from)

**3. Operational Risk**

- f. Income Statements, Balance Sheets & Statement of Cash Flows
- g. Funds Managements Policy (Investment quality)
- h. Off-Balance Sheet Arrangements, Commitments, Guarantees and Contingencies
- i. Management Team
- j. Merger & Acquisition History & track record of integration and accretion of value
- k. Management Discussion and Analysis (MD&A) and Safe Harbor Statements (Financial Statements, Call Book, etc.)

- l. Ownership base (broadly-held, high concentration of insiders or Institutional Investors, etc.)

- m. Litigation History (civil and regulatory actions)

- n. Securities Litigation risk (publicly-traded bank holding companies, other)

- o. FDIC Demand Letters.

“This is a very negative event for insurers,” Uhl says.

**4. Oversight Risk**

- p. Board Composition – Are board of directors members former bank operators/executives?

- q. Board process and minutes of board meetings

## How to Present Less-Than-Sterling Financials to Your Insurer

You need D&O coverage, but your financials may not look fantastic. It isn't an unusual situation. The recession put a lot of banks into this boat. How can you make your bank's balance sheet look as good as it can for the insurer?

- Offset the negatives. Some of your financial ratios may not look great, but often you can find positive ratios to pair with the negative ones, suggests Lockton's Sweeney.
- Be proactive. Give the insurer your best case, says Kevin LaCroix, a partner with OakBridge Insurance Services, Morristown, N.J., and the publisher of the *D&O Diary* blog. “Prepare for your meeting with the underwriter so that you're ready to present your bank's best case.”
- Check around. The insurer you meet with may not insure a financial institution with financials like yours, but others might. Different insurers have different levels of acceptability when it comes to ratios, says Sweeney. Some are willing to take on more risk, but don't be surprised when that coverage comes with extra exclusions, Sweeney says.
- Have a plan. If your ratios aren't where your insurer would like for the

coverage and price you want, explain your plans to fix those ratios. Talk to the insurers and let them know what you have planned for the next quarter, Sweeney suggests. “You can work this out. [Having a plan] is favorable news for the insurer.”

- Don't soft pedal the negatives. “If something about your bank needs to be explained, get it out there,” suggests LaCroix. “It's better to be forthright, rather than waiting until the underwriter finds it and comes to feel as if this issue were swept under the rug.”

It's true, agrees John Wells, President of ABA Insurance Services, Mayfield Heights, Ohio. “To the extent that you can disclose information, that's helpful,” he says. “Sometimes, a financial institution worries about disclosing something, but it's much better to get it out. Unknowns are viewed negatively by insurers.”

- Give them the best info you have. You want to make the underwriter's job easy, and you can do this by giving them the best information, LaCroix says. “If there's a good story to be told, tell it with the best data you can get, including trends, loan loss data, write-offs or even stress test results.” ■

r. Audit Committee interface between outside auditors and executive management – has this charter been updated?

s. Compensation Committee Oversight – has the charter been updated?

t. Nominating & Governance Committee Oversight – has this charter been updated?

u. Use of outside consultants

v. Regulatory Oversight, which includes FDIC audits

An underwriter uses lists of red flags like these to gauge a financial institution's susceptibility to the four big risks, Uhl says. "For instance, a D&O insurer relies on the published financials, including call reports, as well as related financial metrics to estimate the safety and soundness of a bank for the next 12 months, which is the

'on-risk' period for the insurance company," he says. "During this analysis the underwriter attempts to get comfortable with peer metrics and also ensure that banks are within acceptable Capital Adequacy ratios – either Tier 1 or Tier 2."

Any deterioration from the mean could indicate to the insurer that the bank in question might be looking at a shareholder claim or a DIF claim within the 12-month policy period, which might result in a loss for the insurer, he adds.

Here are a few more issues sure to turn up at your next meeting with insurers:

- **Asset Quality.** Recently, insurers have become particularly concerned about asset quality, adds LaVonda Alleman, a senior account executive with insurance broker Lockton in Kansas City. Financial institutions should expect

any insurer to take a very hard look at delinquencies – especially the 30- to 90-day delinquencies. "Those [delinquencies] are highly underwritten," she says. "Insurers are looking at them deeply. They'll want to know what's in there. Are the bulk of the delinquencies closer to 30-day or 90-day? Is it mainly commercial or residential? They want to see the trends over several quarters."

"Some banks just don't understand what insurers are looking for," she adds. "They don't understand why it's so critical to explain that 30- to 90-day column."

**TARP.** "Underwriters are questioning TARP heavily, too," Alleman says. "They'll want to know if you took it, if you plan to pay it back, when you plan to pay it back and if you're lending." ■

## Scorecard

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"Fundamentally, this [proposal] is not intended to be about examinations, but rather how [the FDIC] wants to move the fair share of the cost of deposit insurance to the greater risk, which happens to be at the higher end of the [banking] spectrum," he says. "There's a perception that the risk created in the last recession wasn't so much related to bread-and-butter banking practices. Big banks have been getting a subsidy from the community banks."

### Scorecards for Smaller Banks?

Nevertheless, federal regulators can and do test new methodologies on larger institutions, only to

roll out modified versions of them for smaller ones and this one may be no exception, says Joe Daly, a partner in the Washington, D.C. office of Kilpatrick Stockton LLP.

Daly points to one example: For smaller banks, regulators did propose a modified version of the Basel big bank capital standards. If the FDIC likes its new assessment methodology, smaller banks shouldn't be surprised to see it, or a version of it, proposed for them, he says.

"If you look at the criteria the FDIC set out in the proposal – the assessment arrangements, the ratios, the liquidity measures – there's nothing there that isn't adaptable to community banks if the agency chose to do so," Daly says.

"The FDIC is an insurance

company," he adds. "They're always trying to find a better way to measure risk to the insurance fund. I can see the possibility that, if they adopt this proposal and apply it to larger institutions, then at some point in the future, they could adapt it to community banks. This is something [community banks] need to keep their eyes on."

Aspects of this proposal could end up in community bank exams sooner than that, suggests Fischer. "The proposal could appear in a modified, simpler form for smaller banks," agrees Fischer. "The FDIC may start doing some of this on an informal basis – not as a violation of regulation, but simply as a best practice."

On a broader level, the FDIC's

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## Scorecard

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proposal fits neatly into a very pronounced recent trend: the regulators are hyperconscious of risk. "This proposal, the exam process, capital requirements and insurance assessments, it's all tied to risk – risk to the fund or risk that the bank might fail," says Daly. "If they do risky things, institutions should not be surprised if they have to pay the price, in terms of higher capital or larger assessments."

### What Bigger Banks Are Saying about the Plan

The regulators are proposing a methodology too finely calibrated to the recent recession and unless our next recession is just like the last one, the methodology may not be too effective, argues McHenry Kane, a VP and attorney with SunTrust Bank (\$154 billion), Atlanta, Ga. "The proposed system ... would appear to diagnose those risks that financial institutions experienced leading up to the present crisis as opposed to whatever may be the risks that financial institutions will face in the future," Kane writes. "Consequently, those risks that were the primary risks faced by financial institutions leading up to the present crisis are double counted (or triple counted) and would continue to be so even when the financial markets have changed. Many of the risks that are the focus of the proposal are cyclical risks that are most

pronounced during a crisis and less so during good years."

Is the proposed methodology too finely calibrated to the last recession? "I think that's a fair criticism," says Daly. "The FDIC is basing this on a lot of financial issues that came up in the last few years. It's human nature to defend against the most recent concern or problem."

The proposal also gives far too much discretionary power to examiners, adds Joseph Vayda, EVP and treasurer of Key Corp (\$88 billion), Cleveland, Ohio.

"The proposed assessment methodology includes a provision that allows the FDIC to adjust the performance score and the loss severity score by up to 15 points each, up or down, for other significant risk factors as determined by the FDIC," Vayda writes. "Based on the proposed formula and where an intuition falls on the point scale, this adjustment capacity could result in an adjustment of up to 58 basis points in the final assessment rate. Contrast this with the current maximum adjustment of one basis point of the assessment rate for other factors ... Adding a potentially significant judgmental factor could result in a qualitative factor overriding quantitative factors."

Others detect a blind spot for regional institutions in the methodology. Will banks across the country have to deal with a risk assessment methodology designed for and reflective of the worst markets in the country?

Under the proposed methodology, they would, notes Dennis Nixon, president of International Bank of Commerce (\$9 billion), Laredo, Tex. Markets differ, he writes. A risky asset in California may not be quite so risky in Texas.

"The methodology of the proposed system is flawed because it assumes that problems seen in certain regions of the country are problems at all institutions in all areas of the country," writes Nixon. "However, each bank operates under many nuances depending on its regional economy and applicable state law ... Where an institution has found a successful business model in investing in these 'higher risk' assets and has not experienced negative repercussions from the economy, the institution should not be penalized." ■

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