

COMMUNITY BANKS ON THE PROBLEM LIST

ISSUE

It wasn't long ago that community banks were considered a bastion of stability in the financial services sector and the most coveted class of business among financial institutions underwriters. Hard times have hit this sector, which is the largest of the banking industry – 92% of U.S. banks have assets of \$1 billion or less.¹

Of the 106 banks that have failed so far in 2009, the vast majority are community banks.² Of the 416 banks currently on the FDIC's Problem List – up from 305 in Q2 – most are also community banks, which represent almost \$300B in assets. Much of the trouble at small banks can be attributed simply to poor underwriting of loans, as opposed to the exotic financial products that brought down many of their larger brethren. As these bad loans continue to work their way through the system, many community banks will struggle in the face of a declining asset base. Bank failures will continue to rise. Some predict the overall bank failure tally may hit 1,000.³

The FDIC has played a prominent role in the community banking crisis. As a result, its insurance fund fell to \$10.4 billion in 2Q 2009, down from \$45.2 billion in 2Q 2008. There are reports that recent losses have completely eroded the fund and the FDIC will be requiring the banks to prepay their premiums through 2012 to make up the shortfall. The FDIC, however, has not posted reserves and paid

losses in a passive manner and continues to insert itself into the operations and dealings of these problem banks.

IMPACT

The problems in the community bank sector have inspired unprecedented levels of regulatory activity, including oversight and investigations by the Office of Thrift Supervision, FDIC and various state agencies. Defending these proceedings can be extremely costly and underwriters are actively looking into ways to curtail their exposure.

Insolvency, receivership and bank takeovers have all risen dramatically. There has been an increase in M&A activity as healthier banks have seen buying opportunities among their less fortunate peers. We are even starting to see an upswing in IPO activities on the part of community banks. Underwriters have also identified this increased M&A activity as a growing risk factor facing the sector.

As losses accumulate, the insurance market for community banks is changing dramatically. Longtime underwriters of community banks and dedicated underwriting facilities either have exited the business or dramatically altered their risk appetite. The days of community banks simply rolling over their Management Liability insurance package have passed. Blended coverage packages, once readily available and affordable, are now being underwritten as separate policies, and premiums have skyrocketed. Traditional capacity has diminished while terms and conditions have toughened. New players in both the U.S. and the London markets, however, are stepping in to fill the void.



ACTION

More than ever, good risks must be prepared to make their case and differentiate themselves from the pack. Active participation of senior management is likely to be crucial, and tough questions demand straight and forthright answers.

Detailed attention must be paid to terms and conditions, as underwriters seek to minimize exposures in the very areas protection is needed most. Coverage for regulatory investigations can be found but is not standard and must be negotiated. If a policy has substandard “changes in exposure” provisions, solvency issues and M&A transactions can wreak havoc, as policies unexpectedly may be thrown into run-off, acquisitions may be left uncovered and onerous underwriting terms, and additional premium payments may be imposed. These are only a few examples of the pitfalls that may await a community bank with a poorly written policy.

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The observations, comments and suggestions we have made in this report are advisory and are not intended nor should they be taken as legal or financial advice. Please contact your own legal or financial adviser for an analysis of your specific facts and circumstances.

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- ¹ FDIC Quarterly Banking Profile, 6/30/2009.
 - ² FDIC Failed Bank List as of 09/03/09.
 - ³ Prediction by John Kanas on MNBC 8/28/09.