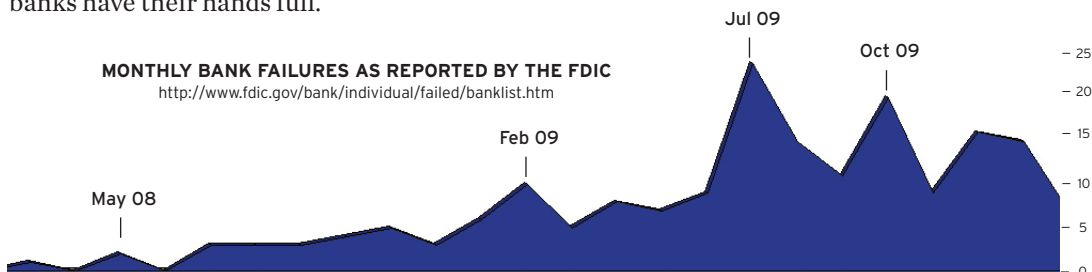


## LITTLE BANKS, BIG PROBLEMS: AN UPDATE

### ISSUE

While the problems at the largest banks have dominated headlines for the last two years, community banks continue to face an equally challenging environment. In our *First Word* on this sector last fall, we noted a spike in regulatory activity that placed a financial and administrative burden on the banks. Now, regulators have even more enforcement actions to monitor. Angry shareholders are taking matters into their own hands and lawsuits are on the rise. The insurance marketplace has taken notice and risk managers at community banks have their hands full.



Despite progress in some segments of the economy, bank failures continue at near record pace. The Federal Deposit Insurance Corporation (FDIC) now deems nearly 9% of all banks in the U.S. as “problem” banks, meaning that they have serious deficiencies that threaten their continued safety and soundness. The problem list is nearly 15 times the size it was four years ago. Community banks, those with less than \$1 billion in assets, represent 92% of the more than 8000 banking institutions in the U.S.<sup>1</sup> – and the vast majority of problem banks.

While many of the problem banks are seeing closer regulatory scrutiny and many are operating under enforcement actions from their government regulators, the regulators are stretched beyond all previous experience. At year-end the Deposit Insurance Fund posted a deficit of \$21 billion and has a contingent loss reserve of \$44 billion set aside to cover estimated losses for the current year.<sup>2</sup> These continuing losses have triggered the FDIC’s requirement for banks to prepay future assessments at a time when many banks can ill afford it.

Normally, the banking regulators close problem banks or help arrange their acquisition by friendly rivals. Even if the government were staffed to keep up, however, a sudden closure of such a large number of banks would almost certainly cause panic among bank depositors and further strain the FDIC Deposit Insurance Fund (DIF). In many cases the FDIC is simply waiting, which in the end may prove to be a wise strategy. The majority of banks on the problem list are expected to recover given time and an improving economy.

### IMPACT

In the meantime, shareholders are pointing fingers at not only directors and officers but also at regulators who are scrambling just to ensure the banks survive. Regulators aren’t the only

ones scrambling. Management is often under duress, facing strict deadlines, looming enforcement actions and close government scrutiny. Bank leadership is more likely to make mistakes in such an operating environment than during periods of prosperous calm.

Where trouble goes, litigation follows. Securities lawsuit filings grew 12% year over year in Q4 2009.<sup>3</sup> Observers expect this trend to continue or accelerate for litigation against community banks. Many shareholders, upset by losses resulting from falling community bank share prices, contend that management and the regulators waited too long to react to the distressed market. Such delays can exacerbate already serious underlying problems. This increase in litigation is reflected in rising insurance premiums.

Underwriters expect increased claims of:

- Breach of fiduciary responsibility
- Inadequate loan loss reserves prior to increased non-accruals
- Management publicly attesting to inaccurate financials prior to 2008 and violations of Sarbanes-Oxley
- Misrepresentation of capital position and loan quality
- Improper disclosure regarding all of these issues

Even if the plaintiffs in these cases ultimately fail to prove their allegations, the carriers must vigorously defend these cases – which is extremely expensive.

## ACTION

Community banks should prepare for tough conversations at renewal. Bank risk managers should brace for:

- Increases in premiums, even for sound banks
- Non-renewal of coverage
- Reduced limits of liability
- Elimination of coverage for regulatory claims
- Increases in deductibles/retentions

- Exclusions of prior acts coverage
- Loss of favorable coverage terms gained in prior years

Some underwriters are withdrawing from the sector altogether, while other new capacity has entered the marketplace offering only distressed terms, very high pricing and excluding prior acts coverage. While these opportunistic underwriters appear to be increasing in numbers, the coverage they provide is limited in scope and expensive. Detailed attention must be paid to terms, conditions and exclusions in these policies. Community banks can expect a rough ride.

## CONTACTS

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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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<sup>1</sup> FDIC Quarterly Banking Profile, 12/31/2009

<sup>2</sup> “FDIC-Insured Institutions Report Earnings of \$914 Million in the Fourth Quarter of 2009,” FDIC press release, February 23, 2010, <http://www.fdic.gov/news/news/press/2010/pr10036.html>

<sup>3</sup> Securities Suits Abound in a Harsh 2009, An Advisen Quarterly Report – 2009 Review, [https://www.advisen.com/downloads/sec\\_lit\\_Q42009.pdf](https://www.advisen.com/downloads/sec_lit_Q42009.pdf)