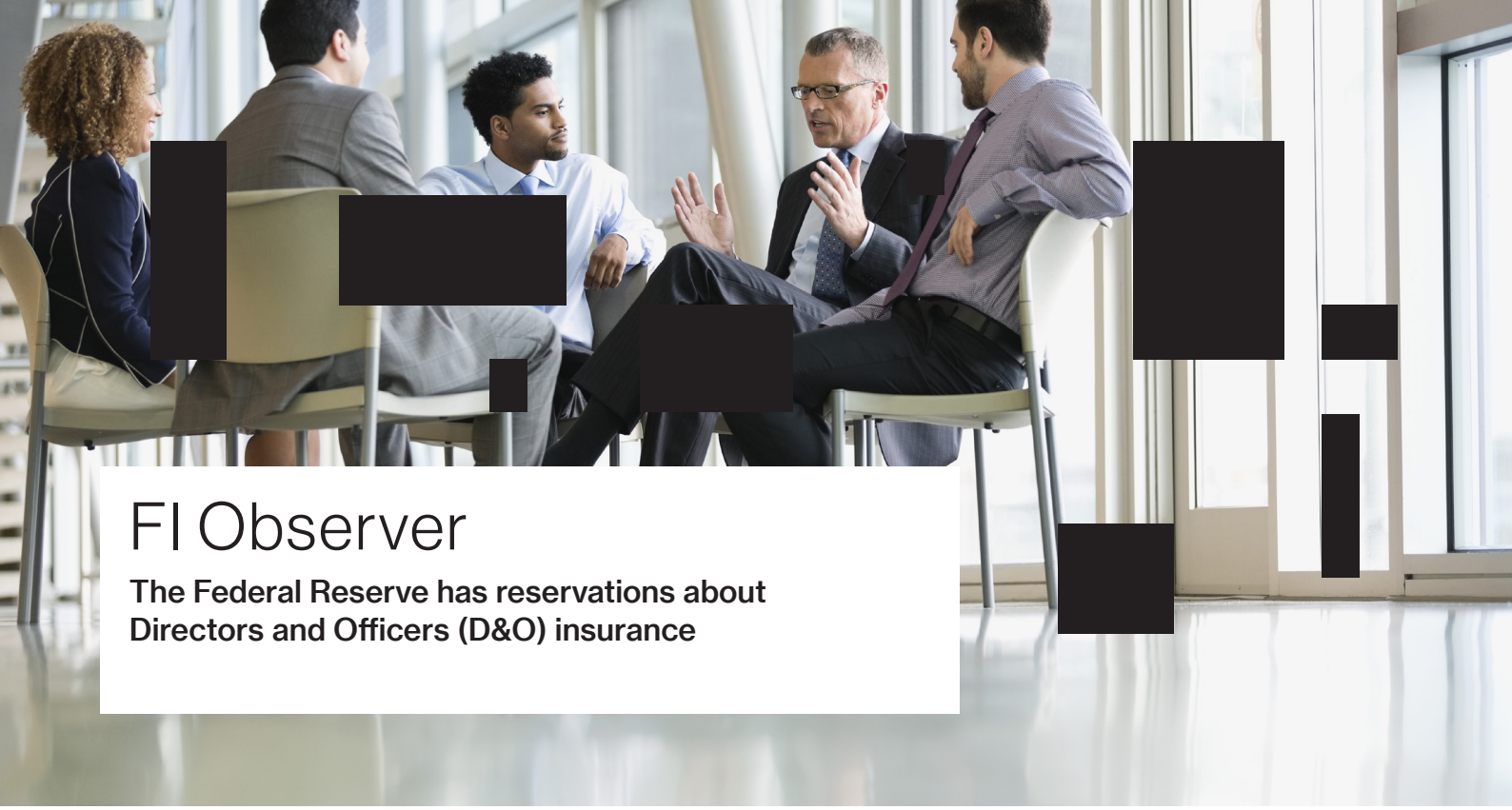

FI Observer

The Federal Reserve has reservations about Directors and Officers (D&O) insurance

The risks of exclusions

The Federal Reserve is cautioning depository institutions to pay close attention to the exclusions contained in their Directors & Officers (D&O) insurance policies.

Issued to covered financial institutions on July 23, 2019, the two page "**Statement Regarding Insurance Policies for Directors and Officers**" borrows **heavily from a similar letter issued by the Federal Deposit Insurance Corporation (FDIC) in 2013**. Signed by Deputy Director Jennifer Burns of the Federal Reserve's Division of Supervision & Regulation, the letter's apparent purpose is to make covered financial institutions and Reserve Bank staff "... aware that insurance policies offering indemnification for D&Os may include exclusionary provisions that potentially limit coverage and leave institution affiliated parties (IAPs) of covered financial institutions liable for excluded claims." The letter states that it is not intended to create any new requirements or examination issues for covered financial institutions that choose to purchase D&O insurance. Rather, the letter's sole stated purpose is to "...inform covered financial institutions of the risks associated with such exclusionary provisions...".

Noting that FDIC regulations presently forbid covered financial institutions from purchasing D&O policies that provide cover for prohibited indemnification payments, the letter cites "...an increase in terms or provisions contained in [D&O] policies that exclude from coverage a wide range of other types of director and officer liabilities."

It is unclear exactly which provisions or D&O liabilities the Federal Reserve is referring to. Nevertheless, the letter makes clear that the ramifications of these provisions – including personal liability for D&Os as well as difficulties recruiting or retaining well-qualified individuals – can be quite severe. The letter also notes that in some instances, D&Os may be unaware of the deficiencies in their firm's policy.

The Federal Reserve's four key queries

The Federal Reserve's letter provides practical advice for selecting D&O insurance policies, including a list of questions to consider when evaluating coverage – especially in connection with renewals or proposed amendments:

1. What protections do I want from my institution's D&O policy?
2. What exclusions exist in my institution's D&O policy?
3. Are any of the exclusions new and, if so, how do they change my coverage?
4. What is my potential personal financial exposure arising from each policy exclusion?

The letter concludes with "...D&O policies are an important risk mitigation tool for financial institutions, and it is vital for directors and senior executives to understand fully the protections and limitations provided by such policies."

Willis Towers Watson

Takeaways

While short on specifics, the Federal Reserve's letter is nevertheless noteworthy in several respects.

First and foremost, it is rare for a financial regulator to weigh in on management and professional liability insurance in general. That fact alone should make financial institutions take note of the Federal Reserve's letter and the advice contained therein.

With respect to the Federal Reserve's call for D&Os to understand the exclusions contained in their firm's D&O policy, there is little to take issue with. As with the FDIC's prior guidance, the four questions put forth by the Federal Reserve are sound and address a common problem. All too often, when D&Os inquire about their D&O cover (and we do not think that this is necessarily as common a practice as it ought to be), such inquiries are generally limited solely to program limits. Rarely do individual D&Os focus on available coverages, wordings, or exclusions. D&Os should therefore take great care to understand exactly how their firm's policy works, as adequate limits will be irrelevant if coverage is denied. Further, as negotiated and often manuscript instruments, there can be great variation in the terms and conditions contained in D&O polices. It is sound advice then for D&Os to seek counsel from an advisor well-versed in the nuances of D&O coverage and the realities of the current insurance market when evaluating whether or not their firm's policy provides adequate protections.

Moreover, this advice should extend to members, partners, and managers at non-public companies as well, who are all too often unfamiliar of the individual liability realities they face.

Why now?

Perhaps the most interesting aspect of the Federal Reserve's note, however, is the timing. To appreciate this issue, one must consider the 2013 FDIC advisory statement which the Federal Reserve's note borrows heavily from and purports to be something of a continuation.

Bank failures

In issuing substantially the same guidance as the FDIC, is the Federal Reserve actually trying to tell us something? When the FDIC's guidance was issued in 2013, a significant percentage of small depository institutions were in danger of failing. According to the **FDIC's statistics**, 489 banks failed between 2008 and 2013. The FDIC Professional Liability Program (PLP) **intervened in approximately 50% of failed banks**, seeking to hold individual D&Os liable for their actions and recovering approximately $1.40 billion.

We discussed the FDIC's letter back when it was issued in 2013. Similar to the Federal Reserve's note, the FDIC's letter was issued for the stated purpose of making D&Os aware of an increase in exclusionary terms or provisions contained in D&O policies. In reality, though containing good advice, the FDIC's statement was also self-serving. Given the wave of failed banks and FDIC actions against the former D&Os, the FDIC had an interest in making sure those individuals had adequate insurance protections to chase. The FDIC was concerned that writers of community and small regional bank D&O policies might try to exclude FDIC suits via the addition of regulatory exclusions, broadened bankruptcy exclusions, or specific FDIC action exclusions. In doing so, the carriers would exclude from coverage PLP actions, leaving the personal assets of individual D&Os as the only source of recovery (which, presumably, would also have been eroded by defense costs).

Aside from ensuring that failed bank D&Os had adequate insurance cover from which to collect damages, the FDIC's statement also sought to ensure individuals could not escape liability from their most serious weapon, writing:

> **"In obtaining D&O insurance, the board of directors should also keep in mind that FDIC regulations prohibit an insured depository institution or depository institution holding company from purchasing insurance that would be used to pay or reimburse an institution-affiliated party (IAP) for the cost of any civil money penalty (CMP) assessed against such person in an administrative proceeding or civil action commenced by any federal banking agency. See 12 U.S.C. § 1828(k)(6), and 12 C.F.R. § 359.1(l)(2)(i). The regulations do not include an exception for cases in which the IAP reimburses the depository institution for the designated cost of the CMP coverage".**

This is a significant detail which the Federal Reserve's letter also briefly touches upon:

> **"In accordance with the FDIC's regulations, a covered financial institution's director and officer liability insurance policies. . .must exclude from coverage a prohibited indemnification payment".**

The FDIC's position has long been that CMPs were uninsurable. In issuing their 2013 guidance, the FDIC formalized that position. Amongst the wave of failing banks, the FDIC wanted to ensure that, in the event they were to seek CMPs against former D&Os, those individuals would feel the pain of their alleged fiduciary failings on a personal level.

Since then, it has become standard practice for D&O policies to generally exclude fines and penalties, and the CMP coverage extension that was available via endorsement to the bank's D&O policy is no longer offered by insurers. CMP cover is still available for purchase by individual D&Os separate and apart from the bank's policy.

So, is this the Federal Reserve's way of setting the table for a wave of potential bank failures and associated regulatory actions against their former D&Os? Probably not. Though their note does come at an interesting time, intentional or not. Talk of a coming recession in the next few years has been heating up amongst trade wars, uncertain interest environment, and political upheaval. The recent unexpected drop in interest rates is straining banks' income statements as loan rates have decreased while deposit rates have not repriced as quickly. Still, there is no specific reason to believe that Federal Reserve is priming the pump for another systemic failure.

The D&O market

The Federal Reserve's note also comes at an interesting time for the D&O insurance market. After a decade of soft rates, a perfect storm of legal, economic, and structural headwinds has led to a hardening of the D&O insurance market. Premiums are increasing (sometimes dramatically) as placements become more challenging. In addition, carriers have begun to slow – but not halt – the pace of product and coverage expansion which had become in many ways the hallmark of competition in a soft rate environment. But we have not yet seen carriers attempt a wholesale rollback in coverage or insert new onerous exclusions such that any regulator – let alone the Federal Reserve - would feel inclined to speak up.

True to the Federal Reserve's note, there are instances in the current market of carriers inserting new or broadened policy exclusions. This is, of course, in and of itself nothing new and it remains good advice (as it always has been) for firms and their D&Os to carefully consider policy language and proposed amendments at renewal. However, these examples are not across the board. Firms contemplating an initial public offering (IPO), for example, will face new exclusions or hurdles imposed by markets as a result of the Cyan decision. With the increasing pace of securities class actions, event driven litigation and the #MeToo Movement, some carriers are also imposing specific litigation exclusions in certain circumstances. But, by and large, it seems unlikely that current market activity is the driving force behind the Federal Reserve's note.

Specialist advice never goes amiss in a complex environment

Whatever their motivations, financial institutions should take heed of the sound advice put forth in the Federal Reserve's note. With economic uncertainty on the horizon and rapid change in the D&O insurance market, now is the ideal time for D&Os and their firms to take stock of their coverages. Particularly as renewals become more contentious, now is not the time to seek the advice of generalists, but specialists well-versed in the nuisances of risks facing financial institutions and the realities of that particular segment of the D&O insurance market.

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