Willis Towers Watson

Banking Market Update - D&O/E&O Insurance

Q2 2020

Executive summary

We are pleased to present FINEX's Banking Market Update for Q2 2020. In this issue, we explore the current state of the Bankers Professional Liability insurance market, and identify new and emerging issues within the banking industry and discuss what impact those issues may have on D&O and E&O insurance policies.

Q2 2020 ushered in the unique and unexpected personal and professional challenges presented by the COVID-19 pandemic. Unprecedented in its scope, the virus itself, along with the market volatility that followed, has had tremendous consequences for virtually all industries and all lines of coverage across the globe. It has been the most significant issue affecting both banks and the D&O/E&O insurance market this quarter and will likely continue to do so for the foreseeable future.

Though the full extent of the virus' impact on D&O/E&O insurance for banks is not known, we do know that the pandemic has added a new layer of volatility on top of an already challenged insurance environment. In particular for banks, the implementation of the CARES Act has presented novel risks, including the Paycheck Protection Program, which we address herein. At the time of this writing, the SBA PPP forgiveness window is set to open on August 10, 2020, which will create a new wave of risk and uncertainty and lenders and borrowers alike navigate the forgiveness process. As a result, insurers are taking a far more cautious approach to the renewal process and are expected to be far more invasive in their underwriting protocols than in years' past. Renewals will be challenging so beginning the renewal process early is critical, as D&O/E&O insurers will likely seek increases in both premiums and retentions, while carefully managing the limits they will provide and scope of coverage they will afford.

Although the COVID-19 pandemic is the most prominent issue currently, we have not lost sight of the fact that other new and emerging issues are also affecting the banking industry. Noteworthy items addressed within this edition include the projected wind-down of LIBOR, changes to the Community Reinvestment Act, cybersecurity, and ESG, among others. We discuss these issues in detail and identify the potential implications they may have on a bank's risk profile, as well as their D&O/E&O insurance policies.

There are many challenges facing banks this year. However, we hope this publication offers valuable insights to help you successfully navigate through these turbulent times. Should you have any questions or wish to discuss any of these issues in greater detail, please engage myself or a member of your Willis Towers Watson team.

Alison MacLaren
alison.maclaren@willistowerswatson.com

Banking Market Update

BPL Insurance Market: Q2 2020 Update

Cost and retentions

- **Rates:** BPL premiums are trending higher with more double digit increases, particularly with the uncertainty that COVID-19 will have on credit and loan portfolios. On average, premiums are increasing by +15 to +35% for large banks and +5% to +15% for mid-market banks.
- **Excess rates:** Decreasing disparity between primary and excess rates with excess generally following primary and underlying increases.
- **ILFs:** Increased limit factors (ILFs) have generally been healthier in BPL than for other lines, but where they are low, excess insurers will seek to right size.
- **Retentions:** Retentions are being reexamined and may be increased to mitigate premium increases.

Markets

- Primary markets continue to push rate increases and excess markets have largely aligned behind those key primary markets on pricing and terms.
- UK and Bermuda markets will consider BPL if retentions and pricing make sense. UK insurers generally need supporting Crime business.
- Newer markets include Markel (community banks), Old Republic (excess), Ascot (excess/wholesale). Great American acquired ABA Insurance Services and is now writing community bank business.
- Breaking relationships with long-term primary and/or excess insurance partners may be required to mitigate premium increases. That said, markets may be reluctant to take on new business for an unfamiliar risk.

Targeted segments

- **Insurer Appetite:** BPL continues to be challenged from a claims frequency and severity perspective and capacity remains restricted relative to other lines. Insurers will look for supporting business on other lines in order to write BPL.
- Less appetite for large banks with >$100B in assets.

Capacity

- **Tightening Capacity:** Insurers with $15M in capacity are increasingly looking to cut back to $10M or ventilate capacity. Insurers are closely managing aggregation across all lines.
- **BPL:** Capacity continues to be limited. Primary BPL markets are becoming more conservative with some pulling back in writing banks with >$10B in assets. Some excess BPL markets have pulled back from new business with the development of PPP litigation.

Coverage

- **Stable to Narrowing Coverage:** Broad coverage is generally still available, though some insurers are reassessing their portfolio and making adjustments to the scope of coverage. Some may be less willing to expand the scope of lending liability, regulatory and investigations coverages and narrow exclusions. Notable coverage developments include:
  - **Cyber Extensions:** Some insurers for smaller to mid-market banks are offering limited cyber extensions to their policies, though such cover is not as broad as stand-alone cyber coverage; if provided, it is important to coordinate with existing stand-alone cyber programs.
  - **Silent Cyber Risk Exclusions:** Some insurers are adding Cyber exclusions to BPL. As insurers continue to assess their silent cyber exposures, we may potentially see similar exclusions added to other types of policies.

Impact of COVID-19

- The impact of the pandemic on D&O/E&O renewals is yet to be fully determined and is evolving daily.
- Generally, insurers are not taking broad negative actions across their book of business, but are assessing each renewal on its own merits.
- Allow for more time in the renewal process and expect several questions relating to both the impact of, and response to, the pandemic.
- Underwriters will focus on lending exposure to distressed industry segments, participation in the PPP, customer communication, regulator interaction, cyber security, and the effectiveness of Business Continuity Plans.

Banking Industry Trends
Key issues to watch

Discontinuation of LIBOR

Observation:

Following years of scandal and fraudulent manipulation, LIBOR will be discontinued Q4 2021. The transition has been described by the NY Federal Reserve as "a DEFCON 1 litigation event if I've ever seen one."

Regulators have promoted the use of SOFR to replace LIBOR in the US. A key issue is how banks will deal with existing "legacy" contracts which reference LIBOR, which according to the ABA includes $300 trillion of existing mortgages, loans, bonds and derivatives.

On June 19, 2019, the SEC advised of risks associated with discontinuation in its Joint Staff Statement.

Concern:

Increased litigation and reputational risk if counterparties perceive changes to the terms of contracts disadvantage them relative to the bank. Query small and mid-size banks' plans to mitigate LIBOR discontinuation, and whether COVID-19 disruption will divert resources from same.

Suggestion:

Confirm in-force LIBOR discontinuation mitigation strategies. Carriers have not yet expressed significant concern over LIBOR issues but may see an uptick in interest as the sunset date approaches.

Community Reinvestment Act

Observation:

The Community Reinvestment Act ("CRA") has attracted increased attention with the OCC's May 20, 2020 issuance of a revised rule. Notably, the FDIC and FRB did not join the OCC.

The CRA was enacted to attempt to remedy historic redlining and lending discrimination policies. The OCC rule changes stress the dollar volume of loans, rather than the number of loans. Critics of the OCC rule claim this will diminish low-income housing investment by banks. Congresswoman Maxine Waters has stated the rule will lead "to regulatory arbitrage and a race to the bottom of weaker standards that will only hurt the people the law was intended to help. . . . [The rule] incentivizes large deals at the expense of smaller and more continuous financial transactions."

Concern:

Because neither the FDIC nor the FRB joined the OCC, banks are now being held to different standards. Moreover, given the recent uptick in social justice reform both the CRA and banks' compliance efforts will attract increased attention.

Suggestion:

Examine lender liability and lending discrimination coverages and identify CRA compliant activities and strategies.

Banking Industry Trends

Key issues to watch (continued)

CECL

Observation:

The Current Expected Credit Losses ("CECL") accounting standard changes how banks account for expected losses on their assets. CECL requires banks to set aside reserves for the lifetime expected losses on loans as time of origination versus when loan losses are probable. The CARES Act now permits banks to temporarily delay using CECL to measure credit losses until the earlier of December 31, 2020, or the date on which the COVID-19 national emergency declaration terminates.

On March 27, 2020, the FRB, FDIC, and OCC issued a rule stating that banks required to adopt CECL in 2020 may delay for two years an estimate of CECL's effect on regulatory capital.

Concern:

Implementation of CECL in conjunction with COVID-19 related challenges and subsequent loan defaults requiring CECL accounting may have put banks' ability to comply at risk.

Suggestion:

Examine policy language for impediments to coverage and address limit adequacy. Banks may need to speak to preparedness in light of COVID-19.

Cybersecurity

Observation:

The FDIC and OCC issued a Joint Statement on Heightened Cybersecurity Risk on January 16, 2020. The statement's intent is to remind supervised banks of cybersecurity risk management principles as articulated in various interagency resources. Banks are urged to be prepared for a worst-case scenario and maintain sufficient business continuity planning processes.

The statement also warned of "heightened risk from cybersecurity threats, such as increased geopolitical tensions and threats of aggression . . . . In recent years,disruptive and destructive attacks against financial institutions have increased in frequency and severity."

Concern:

Increased regulatory attention on cyber issues and heightened risk leading up to the 2020 election. COVID-19 work-from-home network vulnerability and new malware.

Suggestion:

The adequacy of any Cyber insurance currently in place should be reviewed on a regular basis, including the scope and limitations of such coverage and how the policy interacts with other insurance programs. If no Cyber program is purchased, explore stand-alone options or potential Cyber extensions to the D&O/E&O policy.

Banking Industry Trends

Key issues to watch (continued)

Lender Liability

Observation:

Lenders may be held liable for a borrower's financial losses related to the lender's actions. A lender is potentially liable for (1) loans made in bad faith, (2) refusing to advance new loans or credit extensions after promising to do so, (3) taking a controlling interest in the borrower's business, or (4) foreclosing on borrower's assets without proper procedure and notification.

Concern:

Lender liability is a persistent risk for banks. Influx of COVID-19 related defaults are increasing risk. Claims are frequently brought by the customer of the bank's customer.

Suggestion:

Evaluate BPL insuring agreement, definitions, and exclusions, including (1) who can bring a covered claim; (2) who is considered a customer of the bank.

Remove or weaken exclusionary language for claims alleging loan discrimination or violations of laws such as Truth In Lending.

Environmental, Social and Governance (ESG)

Observation:

Fitch Ratings released its 2019 report on Banks and ESG, finding that ESG considerations in lending decisions is now mainstream. It reported that medium-sized (assets $100B to $500B) and larger banks (>$500B) were much more likely to apply ESG policies to their lending decisions, or to screen their lending against ESG policies ,than smaller banks (assets <$100B). Regionally, African, W. European, and Latin American banks were more likely to apply ESG polices than NA and APAC regions.

"Transition financing" opportunities, with attractive spreads, are available for banks interested in financing high ESG-risk entities that are committed to mitigating their climate change and transition risks over time.

Voluntary ESG industry standards are articulated in the UN Principles of Responsible Banking, the Equator Principles, and OECD's MNE guidelines.

Concern:

Complexity of due diligence for ESG compliance of entities downstream of borrower; reputational risk; inadequate disclosures or over-promising.

Suggestion:

Underwriters will expect banks to be focused on ESG. Be prepared to identify ESG strategies.

Banking Industry Trends
COVID-19 impacts

Mortgage Forbearance

Observation:

The CARES Act provides mortgage forbearance assistance for individual homeowners. Individuals experiencing hardship have the ability to request forbearance for an initial 180-day term, and up to a total of 12 months, for federally backed mortgages.

Concern:

Lenders and servicers face potential complaints from borrowers who feel that the terms of their forbearance were not adequately explained to them, particularly if certain borrowers are being treated differently from others with respect to repayments.

Servicers also have an ongoing duty to make payments to the investors of mortgage backed securities. Absent the cashflow from loan payments made by borrowers, nonbank mortgage servicers face a potential liquidity crisis.

Modifications to loans serviced but not owned may also be a concern. The last large-scale wave of mortgage restructurings and modifications during the 2008 financial crisis generated litigation against servicers who voluntarily restructured mortgages by MBS investors who bore the losses.

Suggestion:

Lenders should be prepared to speak to their forbearance procedures and liquidity position.

Overdraft Fees

Observation:

Overdraft fee litigation is rampant against banks. Having been instructed to work with customers affected by COVID-19, many institutions are choosing to waive overdraft or nonsufficient funds fees. Commentators and government officials have been calling for mandated overdraft relief.

Concern:

Predatory assessment of fees over the duration of the COVID-19 crisis may result in litigation on a class basis. Plaintiffs commonly allege that a bank re-ordered debits and deposits to increase frequency of fee accruals.

Suggestion:

Assess BPL policy for broad language excluding coverage for “fees”. Courts have recently construed this language to deny coverage to an insured bank under its BPL policy for an overdraft claim. Note that most carriers are not willing to expand policy wording to include coverage for overdraft fee litigation.

Banks should be prepared to identify overdraft policies and procedures and query benefit of re-evaluating or suspending same in light of the current environment.

Banking Industry Trends

COVID-19 impacts (continued)

Paycheck Protection Program

Observation:

The SBA Paycheck Protection Program began on April 3, 2020 and has been extended through August 8, 2020. The CARES Act allotted $659B for PPP, which provides small businesses with less than 500 employees with short-term, low interest loans up to a maximum of $10M. Loans are reimbursed by the SBA and forgiven if primarily used for payroll costs, though forgiveness metrics have changed.

Concern:

Concerns exist over the degree to which banks may be responsible for verifying borrower information under time pressure, and then later held liable if a borrower obtains a loan after providing misleading information. For this reason, some banks used gating procedures to limit participation, which prompted litigation by would-be borrowers. After funds have been disbursed, forgiveness eligibility calculations will present new risks, and may be handled in conjunction with vendors.

Suggestion:

Banks should be prepared to discuss the extent of their participation in the PPP, and internal procedures for vetting borrower requests. Assess lender liability cover to ensure broad wording. Evaluate loan servicing and other definitions that may apply to forgiveness assessments. Consider vendor related insurance concerns.

Main Street Lending Program

Observation:

The Main Street Lending Program launched June 15, 2020, offering up to $600B to small and midsize businesses otherwise unable to borrow via the PPP. Participating banks would offer five-year loans of between $250,000 and $50M and can be used to increase the size of existing loans up to $300M. Unlike the PPP, the loans are not forgivable, but borrowers pay no principal during the first two years, and no interest during the first year. The Fed takes a 95% stake in each loan, and banks may collect a 1% fee on the loans.

Concern:

70% of each loan will be due in a lump-sum payment at maturity. If a borrower cannot comply, banks will either refinance the loan and assume all of the credit risk on the new loan, or put the borrower into default. The loans will need to be underwritten with higher standards than the PPP loans, since repayment is required. Creditworthy borrowers who can obtain loans elsewhere are likely to forego the MSLP in favor of better terms outside of the program, leaving potentially less desirable borrowers in the lending pool.

Suggestion:

Many banks have declined to participate in the MSLP. Banks that are participating may, as outliers, attract increased scrutiny and should be prepared to speak to level of participation and strategy for same.

Banking Industry Trends

COVID-19 impacts (continued)

Stimulus Check Deposits

Observation:

The CARES Act provided for Economic Impact Payments of up to $1,200 for individuals and married couples getting up to $2,400. Families receive an additional $500 per child. Direct deposits of stimulus payments began April 11, 2020.

Concern:

Banks may face scrutiny over treatment of CARES Act stimulus check deposits and liability may exist for banks that apply stimulus funds to satisfy delinquent debts or overdrawn accounts.

The federal government has equivocated on the permissibility of such action and has guided banks to work with their own legal counsel to determine how to proceed. On Monday, April 13, 2020, twenty-five state attorneys general sent a letter to the Treasury Department requesting further action be taken to prohibit banks from taking these funds.

Suggestion:

Banks should evaluate and be prepared to discuss procedures for how stimulus checks are treated after direct deposit.

Credit Reporting

Observation:

A portion of the CARES Act amends the Fair Credit Reporting Act. The amendment instructs lenders to report that borrowers are 'current' on their credit obligations when a special payment accommodation (like a forbearance) is in place due to COVID-19 related hardship.

These amendments are retroactive to January 31, 2020, meaning that furnishers may need to update information from February or March if accommodations were offered during that time period.

Concern:

Mortgage forbearance or other consumer debt related accommodations are likely to lead to increased disputes by consumers who believe their accounts should be reporting as current. In April and May 2020, the CFPB received ~42,400 and 44,100 complaints, respectively – the highest monthly complaint volumes in its history.

Suggestion:

Banks need to consider notice and reporting obligations at the time of receipt of these consumer disputes, as they are likely to form the basis of future litigation.

Assess the need to revise previous reports for accommodations granted to the retroactive date.

Underwriting Spotlight:
Paycheck Protection Program

Common PPP questions from underwriters:

- Explain the bank's level of participation in the PPP
- Were the bank's PPP loans restricted in any way to certain borrowers, e.g. only existing customers?
- If the bank loaned to new customers, what was the breakdown in loans given to new vs. existing customers?
- What is the breakdown of industries loaned to?
- How much did the bank collect in fees? What amount, if any, is being paid out in fees to agents?
- Was there an audit conducted of originated loans? If so, what were the results and how did the bank respond?
- Discuss how the bank is approaching the forgiveness process.

Each applicable policy of insurance must be reviewed to determine the extent, if any, of coverage for COVID-19. Coverage may vary depending on the jurisdiction and circumstances. For global client programs it is critical to consider all local operations and how policies may or may not include COVID-19 coverage. The information contained herein is not intended to constitute legal or other professional advice and should not be relied upon in lieu of consultation with your own legal and/or other professional advisors. Some of the information in this publication may be compiled by third party sources we consider to be reliable, however we do not guarantee and are not responsible for the accuracy of such information. We assume no duty in contract, tort, or otherwise in connection with this publication and expressly disclaim, to the fullest extent permitted by law, any liability in connection with this publication. Willis Towers Watson offers insurance-related services through its appropriately licensed entities in each jurisdiction in which it operates. COVID-19 is a rapidly evolving situation and changes are occurring frequently. Willis Towers Watson does not undertake to update the information included herein after the date of publication. Accordingly, readers should be aware that certain content may have changed since the date of this publication. Please reach out to the author or your Willis Towers Watson contact for more information.

Willis Towers Watson hopes you found the general information provided in this publication informative and helpful. The information contained herein is not intended to constitute legal or other professional advice and should not be relied upon in lieu of consultation with your own legal advisors. In the event you would like more information regarding your insurance coverage, please do not hesitate to reach out to us. In North America, Willis Towers Watson offers insurance products through licensed subsidiaries of Willis North America Inc., including Willis Towers Watson Northeast, Inc. (in the United States) and Willis of Canada, Inc.

Alison MacLaren
Banking Industry Leader
D: +1 973 315 2058
alison.maclaren@willistowerswatson.com

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimize benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

willistowerswatson.com/social-media

WTW470436/7/2020

willistowerswatson.com

Willis Towers Watson