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

Q4 2020

Executive summary

We are pleased to present FINEX's Banking Market Update for Q4 2020. In this issue, we explore the current state of the bankers professional liability insurance market, identify new and emerging issues in the banking industry and discuss what impact those issues may have on D&O and E&O insurance policies.

By Q4 2020, banks, lenders and insurance carriers alike had adjusted to the new normal driven by COVID-19. Unprecedented in its scope, the virus itself, along with the market volatility that followed, had tremendous consequences for virtually all industries and all lines of coverage across the globe. It has been one of the most significant issues affecting both banks and the D&O/E&O insurance market this year and will likely continue to do so for some time.

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 market. Although provisioning has slowed, reserve levels remain elevated, and the low interest rate environment now facing the industry is cause for concern regarding profitability and potential for a successful shift to revenue generating activities. The implementation of the CARES Act has also presented novel risks, including the Paycheck Protection Program which has recently re-opened for lending. Given this environment, insurers are taking a cautious approach to the renewal process and are expected to be more invasive in their underwriting protocols than in years past. Renewals will be challenging, so beginning the process early is critical, as D&O/E&O insurers may seek increases in both premiums and retentions, while carefully managing the limits they will provide and scope of coverage they will afford.

Although COVID-19 remains topical, we have not lost sight of the fact that other new and emerging issues are also affecting the banking industry. Most noteworthy is the transition away from LIBOR and the resulting uncertainty. As the COVID-19 fallout stabilizes, carriers will shift their attention to LIBOR and the risks it presents within lending portfolios. Other timely topics addressed in this edition are the outcome of the U.S. presidential election and administration predictions, cybersecurity and digital banking, amendments to the Volcker Rule, cryptocurrency, the OCC's recently finalized Fair Access Rule, and some updates to CARES Act-related trends. We discuss these issues in detail and identify the implications for a bank's risk profile, as well as for their D&O/E&O insurance policies.

Banks have faced a challenging year, much of which is expected to extend into 2021. 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.

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Banking Market Update

BPL Insurance Market: Q4 2020 Update

Cost and retentions

- **Rates:** BPL premiums continue to trend higher with double-digit increases, particularly with the uncertainty that COVID-19 has had on credit and loan portfolios. On average, premiums are increasing by +15% to +25% for large banks and +10% to +50% for mid-market banks.
- **Excess rates:** Excess rates are trending upwards as well and may seek increases higher than primary or underlying.
- **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 (+70% or greater).
- **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. Excess markets are adjusting ILFs upwards.
- U.K. and Bermuda markets will consider BPL if retentions and pricing make sense. U.K. 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 are reluctant to take on new business for an unfamiliar risk. There is very limited appetite for standalone BPL.

Targeted segments

- **Insurer appetite:** BPL continues to be challenged from a claims frequency and severity perspective and capacity remains restricted. Insurers will look for supporting business on D&O in order to write BPL. Carriers are cautious of perceived volatility for banks heading into 2021 as COVID-19 fallout remains a risk.
- Less appetite for large banks with >$100B in assets.

Coverage

- **Stable to narrowing coverage:** Broad coverage is generally still available, though some insurers are reassessing their portfolio and adjusting 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, particularly as mid-market banks expand digital capabilities.
  - **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.

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 in light of COVID-related risks.

Banking Industry Trends

Key issues to watch

Discontinuation of LIBOR

Observation:

Despite the disruption of COVID-19, the FCA continues to plan for LIBOR to cease 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 selected SOFR as the U.S. replacement for LIBOR in the U.S.

Concern:

A key issue is how banks and lenders handle "legacy" contracts which reference LIBOR, which according to the ABA includes $300 trillion of existing mortgages, loans, bonds and derivatives. However, on November 30, 2020, LIBOR's administrator announced that many U.S. LIBOR rates will remain in publication through June 30, 2023, which would allow most legacy contracts to mature.

Institutions must now begin issuing non-LIBOR products to ensure working and compliant models in advance of cessation. Inconsistent guidance from regulators and market participants adds complexity and may lead to lack of borrower understanding. Risk to reputation and litigation may also result where counterparties perceive changes to the terms of contracts disadvantage them relative to the bank.

Considerations:

Cessation presents both D&O and BPL exposures. Insureds should expect an uptick in carrier interest through the 2021 renewal cycle.

U.S. presidential election

Observation:

Joe Biden's election as U.S. president suggests a change in regulatory policy away from some of the Trump-era banking policies which softened post-financial crisis regulations. This is likely to impact larger institutions, as there has been bipartisan support for easing regulations for smaller banks.

The Biden win may mean near-immediate change at the CFPB due to the Supreme Court's June 2020 decision permitting the president to remove the director at will, and which may extend to other agencies, including the FHFA. The CFPB had been largely quiet during Trump's tenure and is likely to revive aggressive supervision and enforcement actions under new leadership.

A change in administration is also likely to focus attention on finding a consistent regulatory approach to the Community Reinvestment Act. Regulatory restrictions over marijuana banking may also be lifted.

Concern:

Biden's administration may lead to increased regulation, thereby increasing risk of compliance.

Considerations:

Banks must have robust processes in place to monitor and adhere to shifts in regulatory policy. The scope of regulatory coverage under policies remains a key priority to address any potential lapses or oversights.

Banking Industry Trends

Key issues to watch (continued)

Cybersecurity & Digital Banking

Observation:

The FDIC and OCC issued a Joint Statement on Heightened Cybersecurity Risk on January 16, 2020. Its intent is to remind supervised banks of cyber risk management principles available in interagency resources.

The 2020 S&P Global Market Intelligence U.S. Mobile Banking Report detailed COVID-19's role in banks – "emphasis on innovation in their digital delivery, including their mobile apps, while announcing branch optimization plans aimed at cutting costs." According to the report, YOY branch visits were down up to 42% in some regions.

Concern:

COVID-19 work-from-home network vulnerability and new malware present increased risk. Rise in digital banking and use of biometrics in fraud prevention and AML requires tailored cyber solutions.

Considerations:

The adequacy of cyber cover should be reviewed on a regular basis, including the scope and limitations of such coverage and how the policy interacts with other insurance programs. Explore stand-alone options or potential cyber extensions to the D&O/E&O policy.

ESG

Observation:

ESG continues to remain a hot button topic for all financial institutions, including banks, as Board of Directors grapple with how to manage their risks. On January 14, 2021, the OCC released the final version of its controversial "Fair Access" rule, which requires fair access to financial services, capital and credit based on an individual customer's risk rather than permitting the use of broad category-based decisions. The rule impacts banks with >$100B in assets and is effective April 1, 2021.

Concern:

The rule's intent is to discourage banks from withholding credit from so-called "dirty industries." It has been criticized by the American Bankers Association, which described it as "arbitrary and capricious," inconsistent with accepted risk management, and imposing significant compliance costs, and by Democratic legislators.

Recent litigation against banks for participating in allegedly anti-ESG municipal bond financing, after which city residents were exposed to tainted water sources.

Considerations:

Underwriters will expect banks to be focused on ESG, and banks should be prepared to identify ESG strategy and risk assessments. Litigation and public appetite to hold banks accountable will result in increased defense (if not indemnity) costs.

Banking Industry Trends

Key issues to watch (continued)

Volcker Rule Changes

Observation:

Effective October 1, 2020, the Volcker rule's prohibition on banking entities investing in or sponsoring hedge funds or private equity funds ("covered funds") was modified to remove regulations and thus minimized compliance burdens.

This change presents banks with increased ability to participate in VC and private debt funds and offers new opportunities primarily to large banks.

Concern:

Multiple potential Biden-appointees opposed the revisions, leaving it vulnerable to reversal during his term. Critics of the revisions believe the rollback may leave banks overexposed to risky derivatives and potential fallout may echo the 2008 financial crisis. The changes also portend increased fintech investment by large banks.

Considerations:

The 2020 Volcker rule amendments continue the trend of relaxing the regulatory standards put in place post-2008. Investors have viewed these changes positively, evidenced by the price of industry share prices increasing on the day the modifications were announced. Underwriters are likely to view the deregulatory trend in a similarly positive manner, however, with a careful eye toward the risks identified by opponents.

Cryptocurrency

Observation:

Cryptocurrency continues to move toward the mainstream as evidenced by the January 2021 approval by the OCC of the first federally chartered crypto bank. The approved bank does not offer lending or deposit taking but rather focuses on digital asset custody services on behalf of investors and other banks who cannot offer these services to their customers.

Earlier in January 2021, the OCC issued an interpretive letter permitting banks to use stablecoins to facilitate payment transactions for customers. In December 2020, FinCEN issued a proposal which would subject banks and crypto trading platforms to AML/KYC regulations.

Concern:

Crypto banks had previously been operating solely with the state charter system; a federal charter will allow an institution's offerings to be expanded nationally. By seeking a federal charter and the accompanying regulatory scrutiny, crypto banks are showing a willingness to enter a level playing field on par with other national banks. Despite this, crypto remains a volatile and relatively untested market participant.

Considerations:

Market appetite is likely to be exceedingly limited for cryptocurrency and its emerging risks.

Banking Industry Trends

COVID-19 impacts

Mortgage Forbearance

Observation:

The CARES Act provides mortgage forbearance assistance for individual homeowners. Individuals experiencing hardship may 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. “Robo-forbearance” class actions have been filed alleging banks unilaterally placed borrowers into forbearance to take advantage of incentives.

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, non-bank 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 2008 generated litigation against servicers who voluntarily restructured mortgages by MBS investors who bore the losses.

Considerations:

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

Paycheck Protection Program

Observation:

The SBA Paycheck Protection Program via the CARES Act allotted $659B in short-term, low interest loans up to a maximum of $10M for small businesses. Loans are reimbursed by the SBA and forgiven if primarily used for payroll costs, though forgiveness metrics are in constant flux. An additional $248B was approved in December 2020 and extended eligibility to non-profits.

Concern:

Concerns exist over the degree to which banks may be responsible for verifying borrower information under time pressure and held liable for fraudulent loans. For this reason, some banks used gating procedures to limit participation. This prompted litigation by would-be borrowers, much of which has stalled. Forgiveness eligibility calculations present new risks, and auto-forgiveness remains in question.

Fintech lenders – more apt to automate underwriting – were responsible for only 15% of PPP loans overall but handled 75% of loans found fraudulent by the DOJ.

Considerations:

Lenders should be prepared to discuss the extent of their participation in the PPP and internal procedures for vetting borrower requests. Assess lender liability cover and evaluate loan servicing definitions that may apply to forgiveness assessments.

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 and $500 per child in the first round which began April 2020. The second round of checks offered $600 to each eligible adult and child in December 2020. A third round is under discussion.

Concern:

Banks may face scrutiny over treatment of stimulus check deposits, and liability may exist for banks that apply stimulus funds to debts or overdrawn accounts. The federal government equivocated on the permissibility of such action during the first round and guided banks to work with their own legal counsel to determine how to proceed. In April 2020, 25 state attorneys general sent a letter to the Treasury Department requesting further action be taken to prohibit banks from taking these funds.

By law, the second round of checks may not be used to satisfy delinquent child support or outstanding debt, but individual banks have the choice to apply funds to overdrafts.

Considerations:

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.

Considerations:

Banks and other servicers 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

PPP Underwriting Questions & Topics

- 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 versus 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.

LIBOR Transition

LIBOR Underwriting Questions & Topics

- Discuss the institution's LIBOR transition planning framework and its progress thus far.
- Is the institution on track to meet transition deadlines ahead of the 2021/2023 cessation dates?
- Describe client communication protocols and feedback from clients regarding same.
- For legacy loans, discuss process and procedure for amending fallback language. What is the target completion date?
- Is the institution intending to utilize rates other than SOFR?
- What mechanisms or strategies are in place, if any, to address potential delta between lending and swap agreements?
- What proportion of new loans contain an amendment versus a hardwire approach?
- Identify internal training procedures for staff.
- How has COVID-19 disrupted and changed your LIBOR transition planning?
- How has the revised June 2023 deadline impacted preparations and internal deadlines?

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 notbe 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 Canada, Inc.

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