INSURING LEGAL RISK

by Steve Brown

If your bank is struggling or under a regulatory order, it may be worth spending time and evaluating director and officer (D&O) insurance coverage. Once a bank runs into trouble, analysis finds the risk that additional legal settlements and expenses will result more than quadruples. This goes for the bank, as well as the individuals, as civil lawsuits from regulators, shareholders, employees, other banks (lender liability) and customers often occur. As a result, it is important to understand from a personal standpoint, the potential impact if you are even associated with a troubled bank in order to protect your own personal net worth.

The timing for this question is important, as there are now a small group of failed banks that have settled their respective legal actions, giving us the beginnings of data on which to draw. Prior to the downturn, it was rare for shareholders or regulators to take legal action against a community bank, but now it is becoming more common. For the first time since the 1980's, there is a growing group of former bank directors and officers that have been served notice around the possibility of civil action. While management gets a paycheck for legal risk, the current sentiment is that being a director of a bank in significant regulatory trouble is scary, as the downside overwhelms the upside.

However, we think it is premature to reach that conclusion. In terms of actual settlements or legal action, all of the material ones (like IndyMac) have been as a result of fraud or gross malfeasance. There have been a handful of settlements or legal actions that have largely been deminimus in nature. None have resulted in any material loss that we know of to any officer or director, but here again, the jury is still out since the data set is so small. If your bank is in the group of 95% that have run into problems due to normal credit issues, you are likely ok.

Risk may not be material for most banks and it likely is covered under a bank's D&O policy, but that assumes the policy is sufficient. Many bankers don't check policies until they reach maturity, so one suggestion is for bank officers and directors to have a discussion regarding their true risk and exploring options. Traditionally, many directors have relied on the fact that they had indemnifications from the bank regarding potential lawsuits. However, while nice to have, this isn't really a large risk mitigation technique, since legal risk is embedded in the fact that the bank has failed, so indemnification is likely close to worthless.

Step one is to make sure you understand your policy and schedule. The classic example in the market place right now, is that many directors are shocked to learn that they have regulatory exclusions. That is, legal action brought from the FDIC, would not be covered. A broker can help here, but we believe it is worth setting aside some time at a future board meeting to bring everyone up to speed on coverage and limits. One area to review is as a result of changes due to the new Frank-Dodd legislation. Here, more potential risk is inherent in banks related to consumer compliance.

Next, when you find gaps it is important to get your broker or underwriter educated on your bank. Updating your capital raising plans, liquidity, asset quality and profitability is important to not only gain trust; but also to give a clear picture of the risks and quality of management. Once a bank runs into trouble, there are only limited options, so communication is critical. Many insurers have had to make payouts and as such, they have pulled back sharply from insuring the market, thereby limiting options.

To the extent your bank has insurance options, expanding coverage and limits might be a good idea, as legal risk is undoubtedly higher than we have seen in some time. If you can't expand coverage, at least know where the risk lies.

BANK NEWS

Closed (119 YTD)

Horizon Bank ($188mm, FL) was closed on Friday and sold to Bank of the Ozarks ($2.9B, AR), which acquired all deposits (for no premium), 4 offices and nearly all assets (80% under a loss share). This was Bank of the Ozarks 3rd FDIC assisted purchase of the year. Horizon had a Texas Ratio of nearly 300%.

New Capital Standard

Global regulators agreed to force banks to hold common equity equal to at least 7% of assets, weighted according to their risk, by Jan. 1, 2019. This would include a minimum common equity hurdle of 4.5% (phased in by 2015) and an additional conservation "buffer" of capital of 2.5% (phased in from 2016 thru 2018). Meanwhile, there is also a countercyclical buffer that will have a range of 0% to 2.5% that "will be implemented according to national circumstances" during periods of stress. By 2015, banks will have to begin building the 2.5% conservation buffer that must be fully in place by Jan. 1, 2019.

M&A

First Financial Bankshares ($3.3B, TX) has agreed to purchase Sam Houston Financial Corp, holding co. of First State bank ($164mm, TX), for $22mm. Combined First Financial will operate 11 chartered banks and 52 branches.

Economic Survey

The latest WSJ economist survey finds respondents have cut GDP growth forecasts, with Q3 and Q4 growth now seen at +1.9% and +2.4%, respectively.

Gift Card Changes

Wells Fargo announced it has eliminated monthly service fees (previously $2.50 per month) and increased expiration dates (to 7Ys from 5Ys) on gift cards.