Corporate Governance and Risk Management for Financial Institutions: The Broker's Role

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The FDIC expects more bank failures as the financial crisis continues. On May 27th the FDIC released the Quarterly Banking Profile that represents a report card of the industry status and performance. It concluded that FDIC insured institutions reported a net income of $7.6 Billion in the first quarter of 2009, representing a significant recovery from the $32.1 Billion loss in the fourth quarter of 2008. However, this is 60.8% lower than the first quarter of 2008, a year in which we saw a decline of $32.7 Billion. The fourth quarter of 2008 represented the first quarterly loss since 1990. One third of all insured institutions were not profitable in the fourth quarter of 2008, and overall earnings were outweighed by sizeable losses at a number of large banks. Furthermore, during the first quarter of 2009, twenty-one financial institutions failed; the highest quarterly total since 1992.

In addition to the financial hardships Financial Institutions are experiencing, several other factors are impacting the insurance market:

- The Government Seizure of Fannie Mae, Freddie Mac on Sept 7th;
- Lehman Brothers Bankruptcy on Sept. 15th;
- $85 Billion dollar Government Emergency Loan to AIG on Sept 16th;
- Washington Mutual thrift failure, the largest of it's time, on Sept 26th;
- Dec 11th fraud charges of Bernie Madoff

These factors when taken in concert have driven the insurance market for financial institutions resulting in stricter terms and conditions and higher premiums.

As a reaction to tougher corporate governance, organizations have taken swift Risk Management steps. For example, shareholders at Bank of America approved a motion to remove CEO Ken Lewis as the company's chairman. And, as reported by the Wall Street Journal, separation of these two roles is increasing. Currently approximately 37% of firms in the S&P 500 have separate chairmen and CEOs, up from just 22% in 2002.

The current challenging environment is characterized by a crisis of faith and confidence, extreme scrutiny of corporate affairs, increased regulation, a push for accountability and reform, and heightened exposure to litigation. Understandably then, financial institutions and their intermediaries and insurers find themselves in a whole new paradigm in the D&O marketplace.

As organizations look to better manage corporate governance risk and exposure, insurance, in the form of D&O (Directors & Officers Insurance) remains a key component. A comprehensive D&O policy will protect directors and officers of corporations against damages from liability claims arising out of negligence, alleged errors in judgment, breaches of duty, and wrongful acts related to their organizational activities. The policy also covers the corporation for expenses incurred in defending lawsuits arising from alleged wrongful acts.

"The very reason for D&O insurance is that directors and officers of companies can be sued for everything they've got," says Robert Hartwig, chief economist for the New York-based Insurance Information Institute, an industry organization based in New York.

It all adds up to a brutal environment when looking to increase the effectiveness of your corporate governance Risk Management and Insurance. To cope with these new realities, here's some advice:

- **Weather the storm**. Rest assured, there will be a continuance of this unsettled environment in the D&O sector for a while. On the heels of similar increases in 2002, purchasers of directors and officers insurance currently pay nearly 30% more for their coverage, according to a survey from insurance industry consultant Tillinghast-Towers Perrin. In some cases, premiums have soared as much as 300%, multiyear contracts have been eliminated, and higher deductibles and co-insurance requirements have become standard. This sustained increase in premiums reflects continued concern over high-profile financial institution failures, corporate scandals, and D&O lawsuits. There may be a few faint signs of hope out there, even now, but the situation is extremely tenuous. Another wave of financial institution failures would only compound this trend.

- **Think Risk Management.** In the meantime, think risk management within a corporate governance framework. First of all, never be blindsided by the unexpected; see to it that that risk managers and business managers in your operation are communicating at all times on all issues. Specific risk management tools and processes are available to help you, programs that take into account organizational cultural factors along with the critical risks and fiduciary responsibilities of directors and officers. It's critical to understand the forces driving these new governance models, to use them to diagnose and modernize existing programs in your own organization, and to develop risk management tools to improve them.
- **Hire the best.** Most importantly, find a broker who speaks your language, who understands your business, and who you feel confident will shop the market for the best terms and conditions. While many brokers are capable of "placing coverage" for D&O, it is critical to work with a brokerage with expertise specific to Financial Institution D&O. While premium costs are a critical component, having a knowledgeable broker with the ability to negotiate the broadest terms and conditions is key to best protect your Directors and Officers.

Directors and Officers insurance is a critical piece of your overall risk management platform, both for your directors and officers, and the organizations they serve. Remember, when you have the right blend of a knowledgeable broker and a client that is taking the necessary precautions to "weather the storm", underwriters will look at the strengths of your program instead of assuming the worst. In the end, choosing the right broker will increase the effectiveness of your risk management solution while lowering overall insurance costs.