

The Growing Number of Bank Failures and the D&O Insurance Marketplace

In what has become a weekly ritual as 2009 has progressed, each Friday evening after the close of business, the Federal Deposit Insurance Corporation (FDIC) announces the names of the banks it has taken over for that given week. As of May 28, 2009, the number of year-to-date bank closures stands at 36, which exceeds 2008's year-end total of 25 and already represents the highest annual total since 1993, the end of the last era of failed banks. All signs are that the number of bank failures will continue to grow in the months ahead, a prospect that is affecting the D&O insurance marketplace, even for smaller community banks.

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Background

After the end of the Savings & Loan crisis in the early 1990s, bank failures became rare. No banks failed between June 2004 and February 2007, and only three banks failed during all of 2007. However, beginning in 2008, and accelerating after mid-year, the number of bank failures has reached a point whereby the FDIC is taking control of several banks virtually every week.

These developments have put a strain on the FDIC, which has been described as "in the midst of a military-style build-up as it struggles to deal with a miserable stew of failed real estate projects, vacant land, boarded-up houses and loans to defunct or bankrupt businesses."¹

As might be expected, a number of the recent bank failures have concentrated in certain geographic areas. California, for example, has had four bank failures so far during 2009. Somewhat surprisingly, the state with the highest number of bank failures to date has been Georgia, which the *Wall Street Journal* called "the bank failure capital of the world."² Georgia already has had six bank failures during 2009, bringing the state's total number of bank failures since January 1, 2008 to 11. According to the *Journal*, the state is "haunted by overabundant home building, years of risky lending, and one of the most relaxed regulatory environments in the U.S. for starting new banks."

Even though there is a geographic concentration of bank failures, the epidemic is widespread. Banks have failed in 17 different states so far this year, sprinkled across the national map. Even states whose banks have in the past showed remarkable stability are now experiencing bank failures for the first time. For instance, in February, Maryland had its first bank failure since 1992.

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In addition to the widespread geographic distribution, another surprising attribute of the bank closures so far this year has been their concentration in the community banking sector. According to one standard definition, a community bank is one that has assets under \$1 billion. Based on this definition, the vast majority of 2009 bank failures have involved community banks. 30 of the 36 bank failures YTD have involved banks with assets under \$1 billion. Many of these banks are very small; only 10 of the 36 failed banks have had assets over \$500 million.

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The relevant indicators suggest that the bank closures will continue for some time to come. In the FDIC's most recent Quarterly Banking Profile (as of March 31, 2009), the FDIC counted 305 institutions with assets of \$220 billion on its Problem List. The problem list is up from 252 institutions with \$118 billion in assets at the end of the third quarter of 2008, which in turn was up from 117 institutions with \$78.3 billion in assets as of the end of the second quarter. (The FDIC does not identify the problem banks by name.)

Just to look at what may lie ahead for a single state, the indicators suggest that the woes for Georgia's banks, for example, are likely to continue. According to a March 2009 analysis, over 30 of Georgia's 331 banks and thrifts were at that time judged to be in a "weakened condition."³ The study identified 33 banks that had nonperforming asset ratios above 10%.

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Of the many developments arising as part of the current credit crisis, the deterioration among community banks may be the most surprising and troubling. For many years, community banks have represented the very essence of stability – and, it should be emphasized, most community banks still do. However, growing problems in commercial real estate and rising unemployment levels are exacerbating problems even in the community banking sector, as the number of bank closures described above demonstrates.

Indeed, based on the 2009 bank closures and the prospects for further woes in the months ahead, the community banking sector may now have become a central source of concern in the banking sector. The lead article in the May 19, 2009 *Wall Street Journal* entitled "Local Banks Face Big Losses" reported that commercial real-estate loans could generate losses of \$100 billion by the end of 2010 at more than 900 small and midsize U.S.

banks⁴. The *Journal* noted that these smaller institutions may have trouble replenishing capital to buffer against the losses, which in turn could cause additional institutions to fail.

The D&O Insurance Marketplace

The growing number of bank failures has a number of consequences, including the rise of so-called dead bank litigation. Litigation involving failed banks was a prominent feature of the S&L crisis, and that seems as if that will be the case now as well. Of the 25 banks that failed in 2008, six of them are involved in securities class action litigation, even though only 11 of them were publicly traded. The prospect of further litigation, particularly involving actions brought by the regulatory authorities, seems likely to continue to grow with the rising number of bank failures.

None of these developments have been lost on the D&O insurers, all of whom were already wary of companies in the financial sector - generally as a result of the subprime meltdown and general economic turmoil that began in 2007. Along with the insurers' overall wariness of financial companies, the insurers are now increasingly careful of community banks, which is a recent and unexpected development.

Until recently, the D&O insurance marketplace for community banks had been a quiet area where a small number of insurers offered broad terms at relatively low prices. However, due to the recent deterioration in the sector, the marketplace for community banks has begun to change. There are still a number of leading insurers active in this space, but several have begun to take a more defensive position. Some carriers are reducing their exposed limits. Several key insurers have even begun non-renewing banks with certain characteristics or attributes, or those in certain geographic areas.

In addition, more restrictive terms and conditions are suddenly reappearing in coverage proposals for some accounts. Indeed, the regulatory exclusion, which had become relatively rare, may be making a comeback. Banks with significant exposure to commercial lending or that have elevated levels of nonperforming assets are finding they can place their coverage only for significantly increased premiums. The D&O insurance marketplace for community banks is no longer placid, to say the least.

Perhaps the most noteworthy point about these changes may be how quickly they evolved in this previously quiet corner of the D&O marketplace. The speed of the change in the community banking sector demonstrates the type and velocity of change that can occur in

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a market turn. It is still premature to say definitively that we are headed in to an overall hard market for D&O any time soon, but there is evidence to suggest that a harder market may well lie ahead.

Conclusion

We are (mercifully) still a long way from the dark days of 1989 when banking regulators took control of 534 lending institutions. But we are nevertheless in the midst of the most significant wave of bank failures since the S&L crisis, and evidence suggests that there could be significant numbers of bank failures yet to come. The D&O insurance marketplace has responded to these developments, and several key insurers have adopted a more defensive position regarding community banks. As a result, D&O insurance placements for banking institutions, including community banks, have become more complicated. These developments underscore the value of involving knowledgeable and experienced insurance professionals in the D&O insurance placement transaction for these institutions.

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Endnotes

¹“Failed Bank Poses Test for Regulators” New York Times, February 13, 2009
<http://www.nytimes.com/2009/02/14/business/economy/14assets.html>

² “Bank Failure Central? Try Alpharetta, Georgia,” *Wall Street Journal* (January 2, 2009) <http://online.wsj.com/article/SB123085443910147593.html>

³ “Georgia Banks Face More Pain,” The Street.com (March 31, 2009) <http://www.thestreet.com/story/10479581/1/georgia-banks-face-more-pain.html>

⁴ “Local Banks Face Big Losses,” *Wall Street Journal* (May 19, 2009) http://online.wsj.com/article/SB124269114847832587.html#mod=todays_us_page_one

A version of this article previously appeared on The D&O Diary, the author’s Internet weblog. You can access the weblog via our website at www.oakbridgeins.com. To monitor developments on this and other important topics relating to directors’ and officers’ liability, readers are encouraged to refer to The D&O Diary regularly.

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