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THE INSURANCE PROBLEM IN OUR BOARD ROOMS

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Good morning. I believe my topic today, "The Insurance Problems In Our Board Room," is one that deeply concerns us all. I should tell you I had considered several titles before selecting that one. One of our California colleagues was advocating "BANKING: The Good, The Bad and the Uninsured". A recent Liberal Arts graduate in an alliterative fancy proposed "BEDLAM IN THE BANKERS BOARDROOMS" - but I thought that one could easily be twisted to "BOREDOM IN THE BANKERS BEDROOMS" and I didn't feel that was appropriate . . . or, I presume, accurate.

By whatever name we call it, we all know that insurance coverage has become expensive, scarce and in some cases unobtainable. I want to assure you the FDIC is concerned about this lack of liability coverage for directors. Good directors are essential to our system of banking. Let me share with you some of the things that the FDIC is doing to address the problem, and suggest some steps that might be taken to ease it.

Even a brief look at the insurance market highlights some disturbing trends. In the case of bankers' blanket bonds, the premiums and deductibles have increased dramatically while limits of liability and the scope of coverage have shrunk. Banks are paying much more for significantly less coverage. In addition, a small but growing number of banks cannot find fidelity bond coverage in the insurance market.

The directors and officers (D&O) liability insurance picture, while showing some signs of improvement, is even worse. Some banks cannot obtain this coverage at any price, and those banks with continuing coverage have found that their premiums and deductibles have soared. Limits of liability have been slashed, and policy terms are limited to one year. Policies are frequently riddled with exclusionary provisions which restrict the coverage--sometimes to the point where it is difficult to tell what <u>is</u> and what is <u>not</u> covered. The sad but inevitable result is that many banks have experienced difficulty in recruiting and retaining good outside directors.

Prudent and responsible candidates for these directors' positions are increasingly concerned about their potential liability. Thus, not only have the sources of D&O insurance been diminishing, but the pool of talented, responsible directors may be drying up as well.

If misery loves company, the banking community has a full house to commiserate with. Virtually all lines of property and casualty insurance have become expensive and difficult to find. Hardly a day goes by without reading about doctors, lawyers, fire departments, parks, even entire towns, that face prohibitively expensive liability insurance coverage, or no coverage at all.

There has been much discussion on where the blame lies for this insurance problem. Many blame the insurance industry itself. Insurers blame lawyers, juries, and the judicial system. But all agree that heavy losses have reduced the insurance suppliers' capacity and will to write these types of policies.

Critics of insurers point to a failure to follow sound underwriting standards during a time of intense competition. They say that insurers rushed to capture premium dollars and invest them at high interest rates, but failed to prudently assess and price out their risks. As in most controversies, there are grains of truth in all of these explanations.

I'm sure you are aware that the FDIC also has been blamed as a major cause of bank insurance problems. This is because the FDIC is usually the receiver of failed banks. In this capacity, the FDIC does bring lawsuits against former directors and officers when there is evidence of real negligence or wrongdoing. The FDIC, as fiduciary, has a duty to pursue these claims.

But let me dispel some of the myths that seem to have grown up around these lawsuits by bringing you up to date on our policies. We do not file suit in every failed bank situation . We do not include every former director and officer in suits we bring. We do not file a lawsuit in every case where there is D&O insurance available. We do not ignore a potential claim if there is no insurance. More importantly, no lawsuit is filed without a thorough investigation. In fact, these investigations take time, sometimes up to a year--or even longer--before we decide what action to take.

In these investigations, we attempt to evaluate the conduct of each individual. We take great care in distinguishing the obligations of inside and outside directors. Besides the review process by our senior officials, no suit can be filed without the Chairman's personal review of the case. As still a further precaution, we have been testing a procedure whereby the potential defendants would be advised of our findings and given an opportunity to submit a written statement before any final litigation decisions are reached. Again, our intention is to file suit only where we have found evidence which will make a case and lead to a financial recovery.

Historically, the FDIC has filed lawsuits against directors and officers in approximately two-thirds of our failed banks. However, until recently few banks failed and when they did, it was usually for internal, not external, causes. We are now seeing large numbers of failures attributable to an important extent to economic forces. For example, of the 237 failures and assistance transactions since 1984, 113 have involved farm banks. Clearly, many of these failures were caused largely by economic conditions. Losses sustained because of such conditions would normally not be the basis for a suit against officers and directors.

Finally, it's important to put the impact of the FDIC claims on the insurance industry in perspective. Over the last year and a half, the FDIC has recovered a total of about $50 million on cases involving fidelity bonds and directors' and officers' claims. By comparison, aggregate losses for insurers during this period are estimated at over $1 billion -- and that's net of premiums. The FDIC claims represent well under 1% of the industry-wide loss.

FDIC suits are a factor in, but not a major cause of, the insurance dilemma. Today's problems stem from a culmination of a variety of factors. Trying to fix blame accomplishes little. As Henry Ford said: "Don't find fault, find a remedy." That's what you want; that's what we want! As insurers vitally interested in risk management, we need competent and effective directors in our banks. If their numbers become smaller, the level of risk in the banking industry will grow. So, finding a solution is as important to us as it is to you.

The banking industry is doing several things to attack the problem. Banking groups, including the ABA, have been exploring the feasibility of captive insurers. These efforts could help to increase the availability of insurance. Also the ABA's recent publication, "Developing or Revising a Bank Code of Ethics," incorporates guidelines for directors. It speaks to the responsibilities imposed by state and federal statutes. It spells out the director's duty to investigate irregularities. It defines the difference between erroneous judgments based on sincere effort and those based on lack of concern. Undoubtedly, existing and prospective directors will find these guidelines enlightening and useful. We applaud this effort which should give directors more confidence in their ability to do a "liability-proof" job.

We at the FDIC, have also been doing things. We have been meeting with bankers, trade groups, and insurers to discuss ways to resolve the problem. These meetings help to foster better communication and understanding among the various groups represented. We have shared our concerns with domestic insurers and the London reinsurers. Just last week we attended a meeting in London with major reinsurers. The purpose of the meeting, arranged by Lloyds, was to work toward increasing the number of participants in Lloyds' reinsuring pools. These insurance investors are essential to expanding insurance coverage and reducing costs in the U.S. We think we made significant progress toward dispelling some myths and improving communications and this should lead to better availability of reinsurance.

On another front, the FDIC and the other federal bank supervisors are developing Guidelines for Bank Directors. These guidelines would be based on our experience with failed or troubled banks -- as well as our experience with well-run banks. The guidelines will be general in nature. They are not going to tell directors how to proceed in every conceivable situation. But, a short, plain-English statement of duties and responsibilities, if

followed carefully, should help directors avoid charges of negligence or mismanagement. After all, if would be difficult to sue a director who, in good faith, replies: "I did my job in accordance with the FDIC's guidelines."

Developing these guidelines will take some time. We hope to have them ready early next year. In the meantime, let me share with you some not uncommon characteristics found in failed banks that have caused us to initiate action for failure to exercise proper care.

FIRST: We have discovered, time after time, that in failed banks oversight and internal controls were never established or were bypassed. Directors must exercise care that vital information flows freely to them.

SECOND: Lending and investment policies were not clearly defined and monitored. In this connection, some of the more common red flags that indicate directors may be failing to exercise appropriate supervision include: (1) concentrations of credit; (2) extensions to unknown, out-of-territory borrowers; (3) real estate financing where the borrowers have little or nothing at risk; (4) reliance on loan repurchase understandings--written or otherwise--as a substitute for independent credit analysis; (5) failure to strictly limit insider credit, monitor overdraft reports, and scrutinize funding sources and rates; and (6) failure to regularly and unblinkingly review and revise portfolios and strategies.

Next let me share with you an approach that I know from personal experience has been used by other industries to roll back the number of D&O claims. Importantly, this approach reduces claims by improving the performance of directors. In the mutual fund industry, outside directors began employing independent counsel a number of years ago. Not only were they more effective directors, but they also found that this action helped insulate them from liability claims.

Bank boards should consider following the mutual fund example and provide a separate budget available to independent directors. Outside directors often will need extra help to deal with the complexities of banking. The outside directors could use funding to retain independent counsel to assist them and attend board meetings with them. They could occasionally choose to retain an auditor, an accountant or a consultant. Outside directors might meet separately from the full board to consider reports from their consultants such as evaluations of regulators' examinations.

While the liability issues will not vanish, the courts have repeatedly refused to second-guess wrong decisions if those decisions were made by fully-advised outside directors properly exercising their business judgments. Directors, acting on the advice of competent counsel, would be very difficult targets for suits.

Our friends in London at Lloyds find this suggestion interesting, and perhaps a basis for lower premiums.

This suggestion certainly has its negatives. It may foster some divisiveness in the board room. However, it is not inappropriate to note that many failed banks had amazingly harmonious, agreeable boards.

A separate budget means some additional costs to banks, but this may be recovered through a lower insurance premium, better operations, and fewer lawsuits.

Since I'm on insurance -- I am compelled to let you know how your insurance fund is doing. All things considered, its doing OK! So far this year we have had 117 failures and assistance transactions. We will probably handle another 35 cases before the year is over. FDIC disbursements made or committed will likely approach $4.2 billion. The good news is, after record failures and allowing conservatively (we hope) for losses, we still expect the fund to end 1986 at about $18.8 billion. This is an increase of about $800 million over year-end 1985. We are still profitable. The good news must be tempered somewhat with caution. For one thing, the fund is becoming less liquid: cash and U.S. Treasuries amounted to $15.9 billion or 88% of the fund last year but will probably close the year at about $15.5 billion or 82%. Also, the fund is not growing quite as fast as insured deposits. We expect some modest slippage in the ratio of the fund to insured deposit, which was 1.19 percent last year. Finally, and perhaps of most immediate concern to you, it is almost certain there will not be an assessment credit for 1986.

What about beyond 1986? What will happen? Well, as an astute but anonymous scholar once observed: "Forecasting is very difficult, especially if it's about the future." I can tell you we do not expect a dramatic decline in the number of failures next year. Our problem bank list continues to grow -- it now totals 1,456 banks. Beyond that -- well, that depends upon a lot of things: the economy, the value of the dollar, the price of oil, budget deficits, and debt levels to name a few. I'm afraid there are way too many variables, and way too few constants, for one to predict much with confidence. Let me just say though, I do have some concerns. The debt in this country has been growing at unprecented rates. I'm not convinced this increase hasn't brought with it a decline in debt quality. We must proceed with care -- the flashing yellow caution light is operational. This is why I feel so strongly about the need for good, effective bank directors.

I will conclude by saying I think the deposit insurance fund will face great challenges in the years just ahead. But, I am confident that working together we will meet those challenges successfully.