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The Altered Terms Dilemma: Accept the Offer, Buy Excess or Purchase the Tail?

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Independent agents and brokers handling community bank D&O and professional programs are being asked to make very difficult coverage recommendations to their officer and director clients that could have far-reaching consequences.

State of the Market:

All traditional insurers offering executive and professional liability coverages to the banking industry are scrutinizing each new and renewal bank submission. After years of providing liberal terms and conditions, underwriters are now delaying the offering of renewal terms until closer to expiration in order to be in a position to take action if the community bank's financial condition so dictates.

Underwriters are particularly focused on regulatory issues the bank may be dealing with and are highly focused on loan performance and loan composition. The typical community bank largely avoided the problems associated with subprime investments and had long since lost its predominant market share (& resultant problems) to the 'non-banks'.

However, community banks have traditionally bet heavily on local construction lending and commercial real estate loans. Both are areas analysts predict will be grim for banks in the months and years ahead. Underwriters are also taking a much harder stance on a bank's capital adequacy, profitability, and especially, asset quality and gauging the future viability of their community bank portfolio. The traditional insurers know that it's only a matter of time before the FDIC asserts its receivership litigation rights and regulatory-related claims begin to roll in the door.

What the Marketing is offering:

There's been an unprecedented change in the D&O and professional lines marketplace this past year. Even for banks experiencing only minor financial repercussions from the general economic slowdown, carriers are often offering modified/altered term renewal quotes.

One certain red flag is when a carrier unilaterally offers to extend their current terms for a few additional months. This is often done when a carrier has identified an account for additional underwriting scrutiny due to negative financial trends, claims or litigation issues. Another issue to be aware of is the trend we're seeing of late notification by carriers of those renewal terms.

The results of this additional underwriting scrutiny are re-written terms and conditions by the carrier. Those new terms generally arrive in the form of a 'modified non-renewal' or 'altered terms non-renewal' notice. However, certain carriers are also cancelling 3 yr. pre-paid policies on a mid-term basis if there's been a 'material' decline in the financial condition of your bank client.

While your community bank client is generally offered a renewal and often, the pledge of retaining the original prior & pending litigation dates, that same renewal will in all likelihood often include lower limits, higher retentions, a regulatory exclusion, shared vs. separate limits, and a past due and/or classified asset exclusion.

While the renewal pricing *may* sometimes stay reasonably in line for these renewals, it may have more to do with statutory requirements and the carrier's desire to retain their market share rather than altruistic motives so don't get a false sense of relief. You have a lot to do in a very short period of time. Your bank's executive and professional liability program has significantly changed and you need to know what steps to recommend to your bank client.

What are the Choices?

a. *Accept the non-renewal/modified terms:*

If you've had a long and mutually sound relationship with your carrier, it would be natural to want to maintain that relationship. Your bank's current financial or regulatory difficulties will most likely be overcome at some point and you'll want to return to a standard bank market which generally offers better form and pricing choices.

While loyalty has its place in the market, you need to question whether this is the best choice for the bank and its directors and officers. In the current marketplace, most carriers whose bank customers are having serious problems are expecting the extended reporting period to be elected.

Simply accepting the non-renewal/modified proposal is desirable from the insurer's vantage point as it gives the insurer the ability to reduce their exposure to historical problems. Typically, the carrier will maintain the original prior & pending dates which is certainly of some value, but in turn, they may also offer reduced limits, higher retentions and often a regulatory exclusion. The 'modified' (restrictive) program the bank just accepted may prove wholly inadequate for future claims activity. This recommendation is generally not the one you want to make to your client as a professional insurance agent.

Keep in mind that this modified terms/non-renewal offer not only allows the insurer to retain the bank's business but insulates them from being exposed to the insured exercising their rights to the ERP at higher limits of liability. The importance of a bilateral ERP in your client's D&O program takes on paramount importance in your ability to offer your client further options. There are still some bank insurance carriers that don't offer a bilateral ERP option so make sure to negotiate for this feature in your client's D&O program.

b. *Purchase Excess over the modified terms:*

Choosing this path makes most sense if you're able to negotiate a following form Excess policy 'without' prior acts, past due/classified loan or regulatory restrictions. If you're able to find this coverage, you'd generally only need to locate sufficient excess limits to mostly return your bank client to the same position they were in prior to the modified renewal offering.

However, in this tumultuous bank insurance market with many banks facing current financial and/or regulatory difficulties (and potential failure) this pure following form Excess coverage is generally difficult to find. While you may be able to obtain sufficient excess limits, that excess carrier is more than likely to offer a restrictive program.

Excess terms for bank in difficulties might include a retro-date inception policy, no regulatory coverage, shared vs. separate limits and oftentimes, excess only over the management liability portion of the underlying program. If E&O is offered, Lenders Liability may not be included or, at a very substantial cost with a much higher retention. Be aware of that past due/classified asset restriction as well which largely mitigates the effectiveness of that Lender Liability coverage.

Should you recommend an Excess program with such restrictions, you may rationalize that your bank client will still have limited regulatory coverage for past acts with the underlying carrier (no P&P date advancement). However, provided you had regulatory coverage in your underlying contract, the lower coverage limits the bank accepted might prove wholly inadequate to handle such regulatory claims.

c. Buy the ERP and replace the entire D&O program:

If your client is truly in dire straights and unlikely to emerge from those difficulties for a period of time, this may be your best option, especially if you're unable to negotiate a preferred Excess program.

The good news is that there are a number of highly-rated carriers willing to consider new D&O and professional programs for banks that are currently experiencing regulatory scrutiny and poor financial performance. However, you need to keep in mind that those forms will of course be more limited in their scope of coverage and you'll need to be able to explain those differences to your client.

Another positive note is that we've been in a very soft market and the cost of the discovery period (ERP) coverage should not be a major hurdle in the decision-making process. Generally, this cost will range from 75% to 150% of the prior year's annual D&O premium. The main benefit for your client is full coverage for prior acts during the discovery period which would include regulatory coverage (provided they had it going into the renewal) for at least a period of one year. Again, make sure your current D&O contract has a bilateral ERP provision.

Keep in mind that the D&O replacement program you purchase will likely have no coverage for prior acts or regulatory actions; after all, those carriers are taking on an enormous financial risk. However, you should be able to negotiate with your new carrier higher limits and a solid blended program including EPLI, Fiduciary Liability, Bankers Professional and Lenders Liability coverage. These coverages will be offered on a 'going-forward' basis.

This choice of action provides the new insurer with a clean slate from the historical problems which might encourage them to offer broader coverage. Your client will also have the benefit of a comprehensive one-year 'tail' policy which, while a more costly option, may be your best recommendation. Also, to best protect your directors and officers, the purchase of the ERP should be made in conjunction with the procurement of that new blended D&O policy.

Your client's Board membership is made up of community leaders and business owners whose personal assets are at stake. There's no question that your recommended choice of action when faced with a non-renewal/modified terms notice will have real consequences if not made correctly.