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THE INSURANCE PROBLEM IN OUR BOARD ROOMS

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Good morning. It is a pleasure and privilege to have the opportunity to speak to you today. I'd like to talk about several related topics of concern to you and to the FDIC as your insurer and supervisor.

First, I would like to address the very serious problems in certain insurance markets vitally important to the entire banking community. I am referring, of course, to the markets for bankers' blanket bonds or fidelity bonds, and directors' and officers' liability insurance. Some people have suggested that "problem" is now an understatement, and that "crisis" is more appropriate. I would also like to share with you some of the things that FDIC is doing to address the problem and to suggest some ways that you can and must contribute to a solution. Finally, I intend to propose for your consideration an idea which I know from personal experience has been successful in other industries. While my suggestion won't be an immediate cure-all for the insurance problem, it could reduce the likelihood of claims against directors and officers, D&O insurance policies, and fidelity bonds by improving the performance of many boards of directors. Strong, effective boards benefit us all. They help you and your institutions, your private fidelity and D&O insurers, your federal deposit insurer, and the general public.

Before moving into my discussion of insurance, I want to comment briefly on the subject of non-bank banks. I prefer to call them "loophole banks". I will dispense with this subject quickly by giving you my views. Loophole banks have no place in our banking system. We like competition in banking, but institutions that don't offer the full range of services are unfair competitors.

The symptoms of bank insurance problems are obvious. In the case of the fidelity bond, some banks cannot obtain any coverage. Fortunately only a small number of institutions are in this position. Most banks, however, have found that both their premiums and deductibles have increased dramatically. Limits of liability have decreased and new provisions in the bond may contract the scope of the coverage. The D&O liability insurance picture is even worse. Many banks cannot obtain any coverage at any price. Those banks who have been able to continue prior coverage have found that their premiums and deductibles have soared, limits of liability have been slashed, and policy terms are limited to one year. Equally, if not more significant, the policy is frequently riddled with exclusionary provisions which severely contract the breadth of the coverage — sometimes to the point where it is difficult to tell what if anything is covered by the insurance. The important consequence of this situation is that many of you have experienced difficulty in recruiting or retaining good directors because of their heightened sensitivity to potential liability and concern about adequate liability insurance coverage.

If misery loves company, we in the banking community have a full house with whom we can commiserate. The insurance problems facing banks are far from unique. Virtually all lines of property and casualty insurance have been poor performers. As a result, hardly a day goes by without reading about doctors, lawyers, day care centers, fire departments, parks, or even entire towns and cities who face prohibitively expensive liability insurance coverage or no coverage at all.

There is much finger-pointing going on trying to explain these problems. Insurers generally say that our society is too litigious, and that the judicial system is in need of repair. They also state that heavy losses have reduced their surplus accounts, and thus their capacity to write these types of insurance. Insurers spread their risk in reinsurance markets, of which Lloyd's of London has traditionally been a leader. The availability of reinsurance, however, has decreased markedly due to reinsurer's own large losses, resulting in a further contracting of insurance capacity.

Others contend that the insurers have no one to blame but themselves for their losses. These people point to sloppy underwriting, and a period of intense rate competition fueled by a desire to capture premium dollars to invest at the prevailing high interest rates. In reality, there is probably at least a grain of truth in all of these explanations. Most complex problems have multiple causes.

In the case of bank insurance problems, I am troubled by suggestions I have heard that the FDIC is a major cause of the problem. As most of you know, when a bank fails, the FDIC is almost always the receiver or liquidator of the bank. In that capacity, lawsuits may be brought against former directors and officers on behalf of the creditors and stockholders of the failed bank.

Please indulge me for a few moments as I dispel some of the myths that seem to have grown up around these lawsuits. Contrary to what you may have heard, the FDIC does not file suit against former officers and directors of every failed bank, nor do we include in our lawsuits every former director or officer from the beginning of all time to the date of the bank's failure. We do not always file a lawsuit if there is D&O insurance available, or ignore a potential claim if there is no insurance. No lawsuit is filed without having been preceded by an investigation. As a part of this investigation, we attempt to evaluate the conduct of individual directors and officers, recognizing in particular the difference between inside and outside directors. A recommendation that a lawsuit be filed must have not only the concurrence of some of our most senior officials, but also my personal approval. Many of our lawsuits involve criminal activity, fraud, or insider abuse. In other cases we have found a serious divergence from appropriate standards of care which have resulted in large losses to the bank and exposed your FDIC fund to significant risk.

When these situations do exist, we have an obligation on behalf of the failed bank's creditors and stockholders to pursue a claim. Some of you may have read that historically the FDIC has filed lawsuits against directors and officers in approximately 2/3 of our failed banks. You should remember, however, that in prior years far fewer banks failed; indeed, few among us could deny that in our industry's past era, marked by heavy regulation and light competition, failure could be achieved only by the most inept or abusive bankers. More recently, we are seeing large numbers of failures attributable primarily to powerful economic forces beyond the control of the most astute banker. In such cases it is quite possible that there has been no fraud, insider abuse or even negligence. Many farm bank failures, for example, may fit this latter model, and it would not surprise me if the percentage of cases in which we bring suit in the future decreases significantly. Finally, the amounts recovered by the FDIC on D&O and fidelity bond claims in past years have been an extremely small component of these insurers' total loss experience.

We do not perceive the FDIC as the problem. We do, however, want to be a part of a solution. If competent directors, particularly outside directors, are unwilling to serve on boards because they cannot obtain insurance, we all lose. As insurers ourselves, we are vitally interested in risk management. Competent and effective bank directors are seen by us as essential to maintaining an acceptable level of risk in the system.

We at the FDIC have been meeting regularly with bankers, trade associations, and insurers. I must compliment your own representatives, Chip Backlund and Ken Guenther. They were among the first to contact us to express their concern and to offer their assistance. We have shared with numerous domestic insurers many of the comments I have made today about FDIC's activities and procedures in the D&O and fidelity bond claim areas. These insurers have been pleasantly surprised, and have indicated that the meetings have been helpful — so helpful, in fact, that we all believe it would be beneficial to meet with leaders of the reinsurance markets. My staff and I expect to meet with representatives of Lloyd's in the near future.

A number of groups, including the IBAA, also have been exploring alternative insurance possibilities such as captive insurers. We have been working with these groups, offering our evaluations from supervisory, legal, and practical standpoints. We favor any such ideas that would serve to increase capacity in the insurance or reinsurance markets.

At the beginning of my remarks I mentioned that you, the bankers, must also play a major role in addressing this problem. Although most banks are well run, some are not. Poorly run banks generate claims against directors and officers and D&O policies and blanket bonds. The converse represents a simple truth also: Well run banks spawn fewer claims, and fewer claims cannot help but have a positive impact on the insurance markets.

I won't presume to deliver a lecture on your responsibilities as bankers and those of your outside directors in managing and monitoring the affairs of your banks. I would like to share with you some basic rules of thumb or "Do's" and "Don't's" that could take you a long way towards limiting your potential for losses and minimizing your exposure to claims from shareholders or others. First, establish effective oversight and control systems, including periodic reporting to the bank's board in order to provide directors with a clear understanding of the volume, quality, risk and profitability of the bank's loan and investment portfolios. Time after time when banks have failed we have discovered that systems and policies designed to assure sound banking practices and effective monitoring by directors were never established, ignored, bypassed, avoided or compromised.

Second, there must be well-defined lending and investment policies and an effective means of monitoring their implementation. Nothing is more critical in determining the overall level of risk a bank will assume and its long-range success. In this connection, it is clear that poorly run banks share some common characteristics: (1) unnecessary concentrations of credit; (2) extensions of large amounts of credit to unknown ro out-of-territory borrowers; (3) 100% financing for various types of real estate ventures; (4) reliance on repurchase agreements - written or otherwise - in loan participations rather than independent analysis of credit quality. Well run banks, on the other hand, seem to avoid these pitfalls for the most part. Such banks also seem to have certain similarities in approach. They tend to limit and place high standards on insider credit; to monitor overdraft reports carefully; to pay very close attention to their funding sources and rates being paid and to monitor closely trading account activities for compliance with investment policies. Finally, well run banks recognizing that most markets are inherently unpredictable and limit their downside loss potential by making reasonable assumptions about market conditions and revising their lending and investment philosophy as those conditions change.

These then are some of the areas that especially merit the attention of the managements and boards of directors of banks.

Let me conclude by setting out the modest proposal I alluded to in my opening comments. To set the stage, I will share with you some of my general philosophies of corporate governance. I am a firm believer in the need for a strong, independent slate of outside directors. A well-informed, active board of directors is better able to exercise sound business judgment which, in today's highly competitive and complex environment, is essential to success and, indeed survival. I say this knowing that those of you who are CEOs may privately disagree, preferring instead a passive directorate that can be dominated or manipulated. Some CEOs subscribe to the theory that the way to deal with their directors is to employ good mushroom growing techniques: Keep them in the dark but well-nourished with natural fertilizer.

I believe that outside directors should be knowledgeable of the bank's business — not every day-to-day decision or development — but certainly the most significant ones. Furthermore, outside directors should be able to recognize principal areas of exposure or potential problems, and in those situations become more actively involved in the bank's affairs and less reliant on management. Some of you may think this is an unfair burden to put on outside directors. I do not, nor does the American legal system which imposes personal liability on those directors who fail to meet such minimal standards of care and diligence as I just outlined. But I believe outside directors could use some help in dealing with the increasingly complex issues of today's marketplace and my proposal is an attempt to provide that help.

Both the independence and capabilities of outside directors could be strengthened if banks made a separate budget available to the outside directors. This budget could be used at their discretion and would not have to be large. Outside directors could choose to retain independent counsel to assist them and even 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 and to take up other issues such as evaluations of management. In the mutual fund industry, with which I am familiar, outside directors several years ago began employing independent counsel. Not only were they more effective directors, but they also found that this action helped insulate them from liability claims. This process should also have the effect of better protecting bank management from claims, as well. Courts have shown some reluctance to second guess decisions that result from the proper exercise of business judgment by outside, independent directors.

As I've said, this suggestion is certainly not a panacea. In addition, some of you may view it as yet another intrusion into management's prerogatives. Some may fear that it will foster divisiveness in the board room. While disagreement or contentiousness for no good reason is obviously not desirable, I should also point out that many of our failed banks had amazingly harmonious, agreeable boards. Our experience indicates that the boards of most failed banks relied totally on what they were told by bank management. My proposal would help directors to do their own research and form their own opinions which is no less than you would expect them to do when making personal decisions.

Finally, some may be worried about the cost, particularly for smaller community banks like many of yours. The monetary cost is certainly a legitimate concern. However, in addition to asking "can we afford to do it?" perhaps we should also be asking "can we afford not to do it?".

I have offered this suggestion for discussion purposes only. I welcome and value your opinions on this or any other portion of my presentation.