For Clients Only!
Common Bank Insurance Issues
Version 2018.0

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Introduction

There are issues in every bank insurance program that are problematic. There are processes and procedures that almost every bank should be considering to control risk. My attempt with this document is to provide my clients with an easy to use guide on the troublesome parts of bank insurance.

Comments are welcome. Suggestions are encouraged. Also, let me know if you find typos or grammatical errors. This document is regularly updated, so I want to keep making it better and better.

Also, as all of you reading this are clients, thank you. I started my insurance consulting practice in the spring of 2000 with no idea if this business would support my family. Frankly, the business has thrived. My clients have provided me with a lifestyle that is beyond my dreams. I hope to continue to provide insurance information and advice for a very long time. Thank you for your trust and faith.

Scott Simmonds, CPCU, ARM
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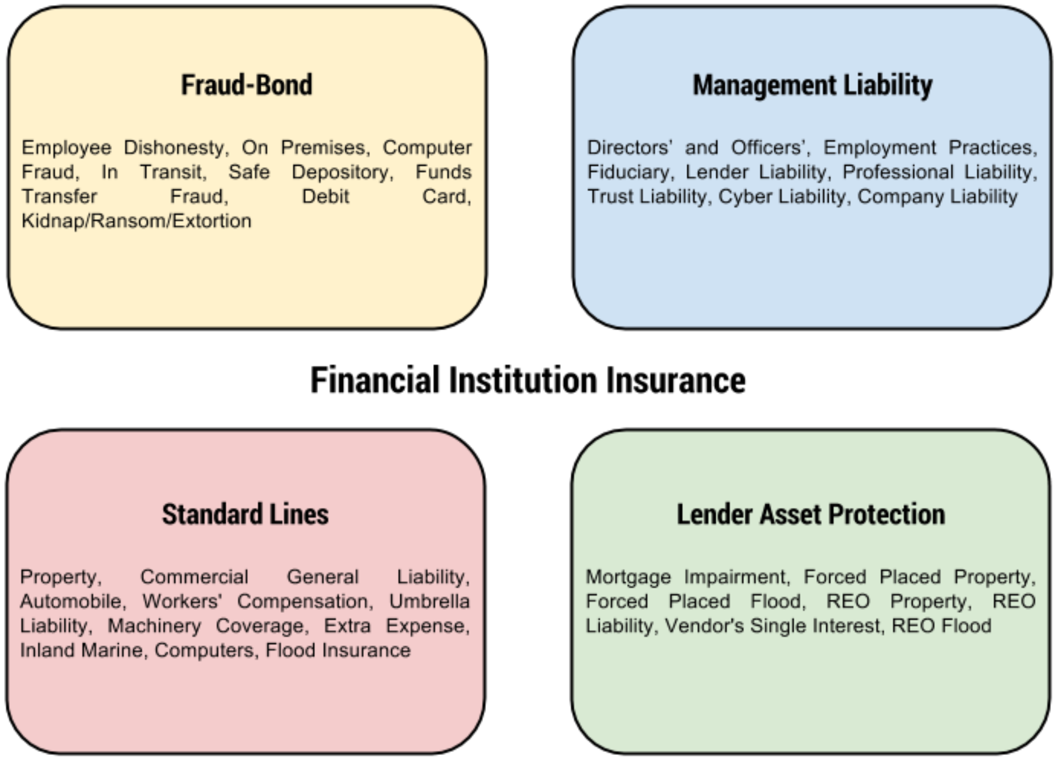
The Four Parts of Bank Insurance



I divide bank insurance into four parts.

The Fraud Bond
Management Liability
Standard Lines
Lender Asset Protection

The fraud-bond provides coverage against loss to the bank's assets caused by fraud. The claims never involve a lawsuit against the bank.

Management liability insurance includes directors' and officers', employment practices liability, fiduciary, lender liability, and other policies against lawsuits from allegations of bad decisions. The claims always involve the threat of lawsuit and do not involve bodily injury or property damage.

The standard lines of insurance include policies commonly purchased by almost any business. Property, general liability, auto, workers' compensation, and umbrella liability policies are included in this division of bank insurance coverage.

Lender asset protection insurance protects the collateral in the loan transaction. Coverages include mortgage impairment, REO property insurance, forced placed coverage, and vendor's single interest insurance.

Fraud-Bond: Employee Dishonesty Loss Involving a Loan

Almost all fraud-bonds include a provision that excludes coverage for employee dishonesty when the mechanism of the theft includes a loan and the employee acts independently.

Your insurer is telling you that your loan process must include checks and balances so that no dishonest loan transaction can be set in motion without collusion from another party. Loans include mortgages, lines of credit, home equity loans, and loans using chattel as collateral.

Fraud-Bond: Dishonest Employee “Must Benefit” Exclusion

The bond is designed to pay for fraud losses. Employee dishonesty insurance is the first coverage section in most bank-fraud bonds. Coverage is limited to those acts where the fraud is the cause of loss. A tool insurers use to restrict coverage is a provision requiring that a financial gain is attendant to the act. Such removes losses where incompetence or failure to follow procedure causes a loss to the bank.

Put another way: for coverage to respond, your bond requires intent to harm the bank and a benefit to the employee who did the deed. So-called, “faithful performance” issues are not covered.

Commercial Customer Crime Insurance Education

Helping businesses understand their risks can help you manage your own risk. Consider an educational program for your commercial customers, urging that they purchase crime insurance – employee dishonesty, computer fraud, and cyber liability insurance. I have prepared a one-page white paper and a video some banks are using in their educational efforts. Both can be found at www.ScottSimmonds.com/BankCustomer.

Fraud-Bond: Dishonest Employee Bond Exclusion

Your fraud-bond protects the bank from loss by employee dishonesty. All fraud-bonds have a coverage limitation/exclusion for acts by an employee known to have committed a prior dishonest act – with little regard for the extent of the dishonesty, when it occurred, or under what circumstances. I suggest the following letter be sent to your senior officers annually, and that the leadership of the bank be open to discussing issues brought to your attention in this process.

> Dear Officers & Directors,
>
> As you know, the bank's insurance program covers losses from employee dishonesty. Nobody wants to think about someone we trust stealing from us. It is, however, a fact of life that people sometimes let us down.
>
> Ours is a business of trust. We must have total faith in the fidelity of our employees. Part of your duty is to protect the assets of our bank.

Tell us if you become aware of an employee’s dishonest act, current or past. Frankly, no matter is too small to consider, since our insurance excludes acts by employees who are known to have committed a past dishonest act, almost without limit to the extent of the dishonest act or to the time elapsed since the event.

Here are some issues that could lead to coverage exclusion:

Shoplifting - even in the distant past, and regardless of if the person was “caught” or not.

Past criminal activity, without regard to conviction or acquittal on the charges. Not guilty is not the same as innocent.

Lying or stretching the truth on an employment application/resume.

Failure to pay taxes/filing false tax information.

Filing false or misleading reports in their work for the bank.

Dishonesty while working in volunteer activities. Again, without regard to criminal charges.

Managing the risks we face protects our bank assets, including the asset of our reputation. I am glad to speak with you if you have questions about this issue.

<<CEO/President Signature>>

Should you become aware of a past issue with a particular employee, you must report it to your insurer so as to receive a waiver on that employee. Let’s discuss specific situations as they come up.

Fraud-Bond: Fraudulent Loan Collateral

There is no coverage in a financial institution fraud-bond for a fraud loss where the fraud is in the determination of the value of the collateral.

Example: You take a loan secured by inventory and it turns out there is no inventory. No coverage.

Insurers are unwilling to be in the fallback position in the bank’s valuation of the security in a loan. Bankers must take due care when securing a loan that is not collateralized by real property.

There is limited coverage for fraudulent mortgages when a loan proves to be defective by reason of the signature being obtained through trick or fraud, or the signature on the recorded deed being obtained by fraud. This is for fraudulent mortgages only. A chattel loan does not have such coverage.

Liability Insurance Gap: Construction Defect Coverage

The insurance industry has no stomach for claims of faulty construction and construction defect. These losses most often affect developers and contractors. However, if your bank forecloses on an active development project, you become a contractor when you take over, then sell to another developer. Even if your bank never raises a hammer at the site, you can be found by the courts to be a part of the chain of owners who failed to properly construct a building.

Some banks have set up separate entities such as LLCs to own foreclosed properties on the theory that such provides a layer of protection against lawsuits from property owners downstream. Talk with your attorney about this strategy.

Liability Insurance Gap: Pollution Liability & Cleanup Expense

It is best to assume that your bank has no coverage for pollution liability or pollution cleanup expenses. The coverage provided in most insurance programs is not enough to include in a risk management plan.

Assume you have no coverage for your bank locations and no coverage at foreclosed properties. Specific pollution coverage is sometimes available for banks. Expect to pay at least ten thousand dollars for the coverage – if you can find it.

The use of real estate holding companies and LLCs may be a viable strategy. Banks often walk away from properties with potential pollution hazards rather than foreclosing.

Management Liability: Defense Costs

Your directors' and officers' policy, employment practices liability, fiduciary liability, and the other coverages within the management liability insurance realm include defense costs in the limit of insurance. As you pay lawyers, you are using up your insurance. Such is a part of the consideration in the limits of insurance you should buy.

> Example: If you have $3,000,000 of employment practices liability insurance and a claim costs you $350,000 to defend, you only have $2,650,000 insurance left to pay the judgment or settlement amount.

Management Liability: Coverage Section Aggregate Limits

Your directors' and officers' policy, employment practices liability, fiduciary liability, and the other coverages within the world of management liability insurance include aggregate limits of insurance.

> Example: If you have $3,000,000 of employment practices liability insurance and you have a claim that costs $1,750,000, you only have $1,250,000 of coverage left to pay a subsequent claim.

Management Liability: Policy Aggregate Limits

Your directors' and officers' policy, employment practices liability, fiduciary liability, and the other sections within the management liability insurance policy may include a limit of coverage for the total of all claims.

> Example: A management liability policy with a 10,000,000 policy aggregate means you have $10,000,000 of coverage for all your claims: directors' and officers' policy, employment practices liability, fiduciary liability, and cyber liability.

Management Liability: Directors and Officers From Nonprofit Service

Your insurance includes an extension of coverage for your directors and officers who serve as directors for not-for-profit organizations. Coverage is limited.

The wrongful act must arise out of service to a nonprofit -- the entity the bank director or officer is serving must be a nonprofit. United Way, Boy Scouts, Rotary, Kiwanis, and the local YMCA are examples that would almost always fall within the coverage. A trade association or a chamber of commerce may or may not qualify as a nonprofit. When in doubt, talk with your insurance company.

The service must be at the direction of the bank -- a bank officer who is a trustee of a church may not meet this test. Serving on the board of the local little league may also be problematic if there is no suggestion by the bank that the officer perform such voluntary service. Periodically have officers and directors of the bank report their community service. With this information, the bank can decide what service it wants to have included.

Coverage is excess over any indemnification by the nonprofit -- most corporate bylaws include a provision for indemnification of officers and directors. In other words, if a director is sued, the nonprofit will provide protection for the directors using the assets of the entity. Those assets must be completely depleted before your bank D&O will step in.

Coverage is excess over any available insurance to the director -- if the nonprofit has D&O insurance, the bank's D&O will be excess. The nonprofit's insurance pays first.

Employment Practices Liability: Fair Labor Standards Act Claims

Your insurance coverage probably does not include defense costs or award coverage for claims brought by employees alleging violation of wage hour and fair labor standards act claims.

Your Contracts Include Broad Requirements For Indemnification

I'm glad to review any contract for insurance and indemnification provisions. Your insurance may or may not respond to your contractual assumption of liability. The biggest “offender” here is the requirement in most core-processor and computer service provider contracts that you indemnify the vendor. Provide me with the contract and I will give you my read.

Common Property Exclusions

Your property insurance contains a number of exclusions. These include: flood, surface water, earthquake, sink hole collapse, volcanic eruption, mudslide, mold, fungus, mildew, asbestos, lead, pollution, animals, insects, rot, and decay.

Common General Liability Exclusions

Your property insurance contains a number of exclusions. These include mold, fungus, mildew, asbestos, pollution, lead, rot, decay, year-2000 type issues, do-not-call list violations, construction defect, exterior insulation and finish, construction operations, property management operations, professional liability, inspections, appraisals, fiduciary liability, and trust properties liability.

Poor Coverage For Broad Intellectual Property Issues

The standard bank insurance program does a poor job of insuring copyright and patent issues. Patent “trolls” are moving into the banking world. Claims for patent infringement in ATM transactions have hit many banks. Insurance is virtually non-existent for this exposure.

Fund Transfer Fraud – Callbacks/Verifications

Your fraud-bond can provide coverage for a fraudulent transfer of funds. Almost all insurers require that you follow a callback procedure so as to identify that the person requesting the transfer is authorized. Different insurers have different requirements. Some require a specific record of the callback. Some require you have an agreement in place with each customer on how the transfer will be checked. One insurer is frequently requiring that callbacks be actually audio-recorded, and the recordings stored.

Review your procedures regularly. Test your system. Audit compliance.

Damage To Personal Vehicles On Bank Business

Jane has been an employee of your company for many years. She is a good and faithful employee. On her way back from a meeting in the next city, a truck kicks up a stone that breaks Jane's windshield. Jane is now in your office asking you to pay for her windshield.

It's a common occurrence. Many employees expect that you will pay for damage to their car while they are driving on company business. Some think you have insurance to cover it.

Would you pay it? What if the damage was $2,500 and Jane didn't have collision insurance?

Set your employee expectations. Let employees know your policy by sending an annual reminder.

Here's my suggestion:

> Dear Employee,
>
> From time to time it may be necessary for you to drive your personal vehicle on company business. The purpose of this letter is to remind you of our policy.
>
> All employees using their personal vehicle for approved business travel will be reimbursed for such use at a rate of .xx per mile. This fee is intended to repay you for your expenses in operating the vehicle, including the cost of gas, oil, tires, maintenance, and the cost of insurance.
>
> We require that all employees who drive personal vehicles on company business carry at least <<$x00,000>> of liability protection and uninsured motorist coverage. The purchase of "comprehensive" and collision insurance is at your discretion.
>
> In the event of an accident while you are driving on company business, you should look to your own insurance to protect you and your vehicle. Remember, the auto insurance you buy is what will protect you on or off company time. Our company automobile insurance policy provides no coverage for your vehicle.
>
> Should you have any questions regarding this memo, please see your supervisor.

Many see my recommendation as harsh. However, I've seen too many instances where employers have caused themselves great trouble by agreeing to pay for these accidents for their employees.

Contractor Management Process - Certificates Of Insurance

Outside contractors are a regular part of the management of any bank. Electricians, plumbers, computer repair, software vendors, janitorial services, landscaping, snow-plowing... Any time you bring a contractor onto your property there is a chance something will go wrong – they might damage your buildings, injure an employee, or injure a customer. Be sure contractors have the correct insurance. This can save you grief. Below is a sample letter that many banks have used to address the exposure of contractors on premises. Require each contractor to prove insurance before they begin work for you.

Note On Limits: The letter below includes limits of coverage. I'm often asked if those are my suggested limits to require of contractors. The short answer is yes. That said, the reality of the community-bank insurance world is that you are probably doing business with some small contractors who are friends of the bank (customers, long-time vendors, or just small business people you admire and want to help). These small contractors often don't have the limits of coverage I'm showing below. You'll have to decide if the relationship is valuable enough to allow a contractor with low limits of coverage to work in your bank. The risk is that something happens and your bank gets sucked into the lawsuit. If that happens, in most cases your insurance will protect the bank quite well. The loss still shows up on your loss record, though. Choices, risks, rewards, and consequences.

<<YOUR BANK NAME>>
Insurance Requirements for Outside Contractors and Vendors

____ ("Contractor"), as a condition of our contract of work, agrees to indemnify and hold harmless <<YOUR NAME>> for all claims for property damage and/or damage for personal or bodily injury, including death, which may arise from acts by Contractor, its agents or associates, and its subcontractors and their agents and associates. Contractor agrees to maintain adequate insurance, in form and with companies acceptable to <<YOUR NAME>>, to insure against the aforesaid, as follows:

Type of Insurance	Minimum Limits of Liability
Workers' Compensation	Per State Law
General Liability (including contractual liability and completed operations and contingent liability for acts of subcontractors)	$1m each occurrence $2m aggregate limit $2m products/completed operations aggregate
Automobile Liability	$1m combined single limit
Umbrella Liability Coverage	$3m aggregate limit

If excavation work is to be completed, no policy may exclude excavation, collapse, or explosion.

Insurance companies must hold a "Best Rating" of A- or better.

The insurance coverage provided hereunder shall be primary to and non-contributory with any other available insurance of <<YOUR NAME>>. Contractor's general liability and automobile liability insurance policies shall name <<YOUR NAME>> as additional insureds, and shall provide <<YOUR NAME>> with a thirty-day notice of cancellation. Certificates of Insurance evidencing the above shall be forwarded in advance of any work to:

<<YOUR CONTACT INFO>>

Contractor Signature: ______________________________________ Date: ________

Name: _______________________________________ Title: _________________________

Contractor Firm Name _______________________________________

Insurance Tracking Condo Unit Owners

A mortgage on a traditional building requires that the bank protect its interest in the structure by tracking the customer's property and flood insurance.

When a bank loans money to a condo unit owner, there are two insurance programs for the bank to track:

- The unit owner's unit-insurance.
- The condo association's insurance on common elements.

I'm finding that many banks are not as diligent on tracking condo association's coverage as they are with their customer's insurance.

Review your tracking systems to be sure they include condo association insurance.

Stop Tracking HELOCs

Tracking your customer's insurance on HELOCs can be expensive in time and effort. Often a better solution is a blanket insurance policy that covers all HELOCs without tracking – and very inexpensive. Let's talk. Often the insurer who handles your forced placed coverage offers blanket coverage.

Consider Outsourcing The Tracking of Mortgage-Customer Insurance

No bank can afford to track their customer's insurance. It is a time-consuming process. New regulations make it almost impossible (so it seems) to be in compliance. Consider hiring your forced-placed insurer to do the tracking for you. Costs are about six dollars per year per mortgage. Outsourced tracking lets bankers be bankers rather than insurance management firms.

Employees Renting Cars

Recommendation - Any employee renting a vehicle for bank business should buy the collision damage waiver coverage offered by Hertz, Avis, etc. While there may be coverage in your auto insurance program (or in the employee's personal auto policy), the reality of the rental world makes it easier and much less hassle to have the rental car company's coverage if you have an accident.

I call this, "The car is damaged - see you later, boys!" coverage - you get to just walk away.

Some clients use credit cards that include "Collision Damage Waiver" as a cardholder benefit. This may save you the daily insurance fee. Call your credit card company first to be sure of the coverage provided.

I usually just buy the insurance from the rental car company.

Build an Understanding of Violent Events

What could be more horrifying than the risk of a violent event at work? The threat of robbery is a part of banking. A disgruntled employee on a murderous rampage is way past what most of us want to ponder. Gavin DeBecker has spent his life studying violent acts. His book, *The Gift of Fear*, takes readers on a tour of abusers, rampaging former employees, and lovers. His insight is invaluable to those of us who are trying to manage risks in our organizations.

Workers' Compensation Claims Management

Workers' compensation claims cause your workers' compensation premium to go up. Look at your insurance policy. In the premium section is the experience modification where your insurer adjusts your premium for past losses. If your losses are lower than average, your experience mod will be under 1.00. A .85 mod reduces your premium by fifteen points. Conversely, losses higher than average will show in a modification of more than one and increase your premiums. Consider the impact that multiplying your premium by a factor of 1.20 would have on your costs.

A culture of safety in the bank will certainly prevent losses. The best loss is the one that never happens.

Banks that ignore the management of the claims that do occur end up seeing loss payments rise.

Consider appointing a single person in your bank to monitor and follow-up on open worker's comp claims. Build a system that stays in touch with injured employees and the insurance company adjuster assigned to the claim. At least quarterly, discuss each active claim with the adjuster, asking three questions:

- What have you done?
- What are you doing?
- What are you going to do?

A process of managing the claims that do happen will pay off in a lower experience modification and lower future premiums.

Conclusion

This paper will be updated regularly and distributed at least annually. Call me if you'd like to know of any issues that I'm seeing in the interim or if you have questions, concerns or need clarification.

I am always at your service.

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