But I Thought We Were Covered!

The Importance of Insurance Due Diligence in a Bank's Risk Assessment Plan

Scott Simmonds, CPCU, ARM
Insurance from an Unbiased Point of View
www.ScottSimmonds.com

How do you know if there is a mistake in your insurance? What if there is an exclusion you don't know about? What if a coverage is missing or improperly designed? What if your coverage is with the wrong insurance company and the policy form isn't the broadest available?

Officers and directors of banks are duty-bound to protect the assets of the bank. A key component of asset protection is ensuring that your insurance program meets the needs of your bank.

Agent Selection and Program Management

Most community banks rely upon their insurance agent for information and advice. I've found that banks select their agents in one of three ways:

> <u>The Agent Is / Was On The Board</u>
> Variations include, "Friend of the Bank," "Big Depositor," and "The Only Local Agent." I've also run into, "Agent is a Stockholder" and "Agent Is Owned By Bank." In any event, the agent has a strong relationship with the bank, as (or almost as) an insider.
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> <u>The Bank Splits the Insurance Up Among Several Agents</u>
> Many banks try to share the wealth. Several agents are selected to manage different portions of the insurance program. The agents may be bank customers or former board members. One agent may provide the bond and the D&O. Another agent handles the package policy, workers' compensation, and auto insurance.
>
> <u>Regular Competitive Insurance Process</u>
> Some banks use a competitive process to select their agent. Every three to six years the bank brings other agents in to provide competitive proposals. The bank may or may not have actually changed agents. However, others have reviewed and bid on the coverage.

Frankly, the way the bank selects its agents, in large part, determines the quality of insurance protection the bank enjoys.

How can the officers of the bank be sure the insurance protection they purchase provides the best combination of coverage and price?

Best Practices

The foundation of a successful insurance program is a regular review of the exposures of the bank, along with an evaluation of the bank's insurance policies. The operation and needs of your bank change constantly. The insurance marketplace for banks also is dynamic. Without ongoing, specialized, expert advice, your insurance program could be out of step with your needs.

Here are some questions to ask yourself about your current insurance:

<u>Is your agent a specialist in bank insurance?</u>
Does your insurance agent work on a regular basis with policies specific to the banking industry such as the financial institutions bond, director's and officer's insurance, mortgage impairment, and forced placed property insurance?

Is your agent proactive?
Does your agent suggest additional coverage and improvements to your program? Are changes in your program initiated by you or by your agent?

Does one agent know what the other one is doing?
If you're working with two agents, are they both aware of the policies and exposures that are being insured by the other? Do the agents communicate with each other?

Who is the expert?
Does your agent depend on your insurance company to answer your coverage questions? Many local agents are unfamiliar with the specialized insurance policy forms used for banks. It's not uncommon for an agent to rely upon the insurance company underwriters for information and advice.

Have you sought competitive proposals?
Has a competing insurance agent reviewed your account and provided a proposal in the past four years? In all aspects of business, competition is what leads to greater value to the buyer. Insurance is no different. Competition can help you control your premiums and improve your coverage.

What's the real reason you are working with your current agent?
How would you answer the question, "Why do you buy insurance from your current agent?" In many cases the honest answer involves issues other than a quality insurance program.

No Right Answers

What is best for your bank? In looking at the totality of your insurance program, is the bank well protected? What if you're not sure? What if an analysis of the questions above leaves you uncomfortable?

Who Do You Call?

The insurance due diligence process is similar to other fact finding procedures - someone with special knowledge reviews the situation, facts, and circumstances. He or she renders an opinion and recommendations. The bank acts on the recommendations.

Step one is to find the appropriate person to perform the review.

There are several sources you can turn to. Perhaps there is an employee of the bank with insurance expertise. You could use your current insurance agent or broker to review your coverage. Another insurance agent or broker could be brought in. An independent insurance consultant could be retained. Some consultants have specific expertise in bank insurance issues.

As you review your options consider the following:

- What experience do they have with bank insurance? Are they well-informed as to coverage and the insurance marketplace specific to banks?

- What opportunities are there for conflict of interest? Do they sell insurance? Are they affiliated with an insurance agency or brokerage firm? Does the adviser accept gifts, commissions, expense reimbursements, or fees from insurance agents or companies?

- If you bring in a consultant, will you be working with the principle of the consulting firm or with an associate?

- If you use an agent or insurance consultant, are the fees fixed or based on the time he or she takes to do the job?

	Advantages	Disadvantages
Bank Employee	Unquestioned loyalty to the interests of the bank. No additional cost to the bank for the work.	May lack current knowledge of insurance. May lack current knowledge of the insurance marketplace. May detract from other duties where his or her expertise is valuable.
Current Agent	Knows the bank. Less investment of time by the bank. Has easy access to past records, loss information, and the account history. May perform the review at no fee in hopes of retaining the account.	Biased in favor of the current insurance program. May miss or overlook current mistakes in coverage design or market. Bias to insurance solutions. Usually commission based compensation - income increases when the premium increases.
Competing Agent	Motivated to find problems. Fresh set of eyes. May perform the review at no fee in hopes of future business.	Biased against the current insurance program. Has an incentive to overstate issues and concerns. Participation may be resented by the current agent. Bias to insurance solutions. Usually commission based compensation - income increases when the premium increases. Greater investment of time as he or she is not familiar with the bank.
Insurance Consultant	Unbiased and independent. Fresh set of eyes. No agenda – nothing to win or lose.	Charges a fee. Greater investment of time as he or she is not familiar with the bank.
Insurance Consultant With Bank Expertise	Possess specialized knowledge of bank insurance and the insurance marketplace specific to banks. Unbiased and independent. Fresh set of eyes. No agenda – nothing to win or lose.	Charges a fee. May be more expensive than an insurance consultant without special expertise. Greater investment of time as he or she is not familiar with the bank.

The Due Diligence Process

The process begins with a review of the exposures of the bank. What are the operating entities? What properties are owned by the bank? What are the business operating units? What are the exposures to loss presented by trust operations, mortgage departments, e-banking, safe depositories, and ATM machines? Does the bank sell insurance? Are there real estate operations or investment advisory services? How prevalent are foreclosures and repossessions?

Next, a review of the current insurance program is needed. What policies are purchased? What are the premiums? Who are the insurers? How financially stable are the insurers? What losses have been paid by the current insurers? What are the current limits of coverage? How is the coverage structured? What penalty provisions are within the policies? What activities and operations are excluded from the current policies?

The third part of the due diligence process is a comparison of the exposures identified and the insurance policies purchased. What gaps exist in the coverage? Are there overlaps? Are whole policies missing from the insurance program? Are the limits of liability adequate? Are the deductibles reasonable based on the assets and operations of the bank?

Is the bank with the right insurance company? What other insurers are competitive within your insurance marketplace? What services can be obtained from the insurance companies to assist in claim prevention and lost control? What services should the agent provide? How can she assist in controlling costs and claims? Should the bank consider a change in insurance agents?

What are the future plans of the bank? If the services of the current insurer and agent are adequate now will they be adequate for the future?

A listing of issues and concerns is then developed. A typical due diligence process may result in several pages of action items. Each one must be researched so that decisions can be made. In many instances the best course of action is, in fact, no action. For example, a bank on the East Coast may have no earthquake insurance. On review and in consideration of the premiums that would be charged by an insurer, the decision is made not to buy additional insurance. Another bank may come to a different decision. However, both have involved a considered assessment.

Timing of the Process

A due diligence process can be performed at any time. The process can work well in the middle of your insurance year or right after a renewal. It can also be fruitful close to the end of a policy year. Use it to prepare or set strategy for your renewals.

The objective of the process is to be assured of the correct combination of coverage and price based upon your bank's exposure to loss. The sooner you can uncover potential problems with your insurance protection, the better.

Scott Simmonds, CPCU, ARM is a fee-only insurance consultant. His practice includes a specialty in bank insurance. Scott never sells insurance and does not accept fees or commissions from the insurance companies or agencies that he works with. He is unbiased.

Scott can be reached at 207-284-0085 or Scott@ScottSimmonds.com. His web site is www.ScottSimmonds.com.

Bank Insurance Resource Center – www.ScottSimmonds.com/bank.html

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