FDIC SAYS NO TO CIVIL MONEY PENALTY INSURANCE FOR BANK DIRECTORS

David Baris
Executive Director
American Association of Bank Directors
1250 24th Street, NW
Suite 700
Washington, DC 20037
(202) 463-4888
(202) 349-8080 (fax)
dbaris@aabd.org
www.aabd.org

AMERICAN
ASSOCIATION
OF BANK DIRECTORS

National Capital Office
Suite 700
1250 24th Street, NW
Washington, DC 20037
Telephone: (202) 463-4888
Facsimile: (202) 349-8080
www.aabd.org

February 3, 2012

Michael Krimminger, Esq.
General Counsel
FDIC
550 17th Street NW
Washington, D.C. 20429

Dear Mr. Krimminger:

It recently has come to AABD's attention that FDIC staff has reversed a long-standing position not objecting to bank directors' purchase of insurance to cover the risk of a civil money penalty, even if the coverage is in the form of an endorsement to a policy in the name of the bank or its holding company. We request that you review this matter and if you agree with AABD, make it known to banks and bank directors that they may continue to purchase insurance to cover that risk.

We understand that last summer, FDIC examiners cited at least two nonmember banks in Louisiana for violations of 12 C.F.R. § 359 for having an endorsement in their D&O policy that would indemnify directors for civil money penalties assessed against them. The policies were issued to the banks, but the banks did not pay for the coverage; the directors did.

This examiner interpretation of Part 359 was subsequently confirmed by an FDIC counsel.

We believe this interpretation is incorrect, as explained in this letter. In sum, neither the FDI Act nor Part 359 prohibits insurance for the payment of civil money penalties so long as the bank does not pay for it.

Summary of § 359 and Section 18(k) of the FDI Act

The provisions of 12.C.F.R. § 359.3 prohibit depository institutions or their holding companies from making or agreeing to make any prohibited indemnification payment except as permitted in the regulation.

"Prohibited indemnification payment" is defined to include any payment (or agreement or arrangement to make any payment) by any insured depository institution or an affiliated depository institution for an institution-affiliated party to pay or reimburse such person for any civil money penalty or judgment resulting from any administrative or civil action instituted by any federal banking agency. 12 C.F.R. § 359.1(l)(1)

"Institution-affiliated party" includes directors. 12 C.F.R. § 359.1(h).

"Payment" generally means any direct or indirect transfer of any funds or assets, any forgiveness of any debt obligations, and the conferring of any benefit (i.e., including stock options or stock appreciation rights). 12 C.F.R. § 359.1(k).

One exception to the prohibition is any reasonable payment by an insured depository institution or depository institution holding company which is used to purchase any commercial insurance policy or fidelity bond, provided that such insurance policy or bond shall not be used to pay or reimburse an institution-affiliated party for the cost of any judgment or civil money penalty assessed against the person in an administrative proceeding or civil action commenced by any federal banking agency. 12 C.F.R. § 359.1(l)(2).

Our understanding is that the FDIC staff has based its interpretation on the language excepting certain payments by a bank or its holding company so long as the insurance being purchased by the bank or holding company does not pay civil money penalties or judgments as provided above.

This interpretation of the regulation is in error. The focus of the interpretation should be on the prohibition in 12 C.F.R. § 359.3 and the definition of "prohibited indemnification payment" in 12 C.F.R. § 359.1(l)(1), not on the exception to the prohibition.

The exception does not apply where there is no prohibited indemnification payment. Since the endorsement to the D&O policy in the name of the bank or holding company that insures against civil money penalties or judgments is not being paid by the bank or holding company, there is no prohibition in Part 359 on the D&O policy having such an endorsement or having the insurance carrier pay pursuant to the endorsement.

Because the endorsement and the payment pursuant to the endorsement are not prohibited indemnification payments, they are authorized under 12 C.F.R. § 359.5 (a). Also see 12 C.F.R. § 359.5(a)(3).

Part 359 tracks the provisions of Section 18(k) of the FDI Act very closely. There is nothing in Section 18(k) that would prohibit a bank director from paying for his own insurance.

Current Insurance Practices

It has been a long-standing practice for insurance carriers to add an endorsement to depository institutions' standard D&O liability policies which provides for the payment or indemnity by the carrier for any civil money penalty assessed against a director. According to common practice, neither the depository institution nor its holding company pays for that endorsement. The premiums for these endorsements are paid entirely by the applicable IAPs. We understand that this practice has existed since at least 1993, the year in which Part 359 was adopted, without protest by the FDIC.

Summary

Part 359 does not support the FDIC staff's recent interpretation that Part 359 bars bank directors from paying for insurance to cover the risk of a civil money penalty or judgment. We urge you to advise banks and bank directors as soon as possible that directors may pay for such coverage, even if it is in the form of an endorsement to a bank D&O policy or other bank insurance policy.

Insurance carrier representatives have advised me that there is a significant administrative burden on both banks and insurers to undo an insurance product that has been in existence for almost twenty years. They have also advised us that the carriers currently have no alternative vehicle to indemnify directors for the risk of an assessment of a civil money penalty. In addition to canceling thousands of existing contracts and attempting to reimburse premiums, a new method of indemnification would need to be created. This might create an increase in premiums because these policies would no longer be pooled into large groups to control the cost of insurance. This could potentially affect other forms of business insurance.

For these reasons, it is important that you act quickly to advise banks and their directors that they may purchase insurance, even insurance in the form of an endorsement to a bank or holding company D&O policy, to cover assessments of civil money penalties and judgments derived from a federal banking agency action, so long as the bank or holding company is not paying for the endorsement.

Sincerely.

David Baris /bp

David Baris
Executive Director

FDIC
Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
General Counsel

February 27, 2012

David Baris, Esq.
Executive Director
American Association of Bank Directors
1250 24th Street, NW, Suite 700
Washington, D.C. 20037

Re: Your Letter of February 3, 2012

Dear Mr. Baris:

Thank you for your recent letter of February 3, 2012. I appreciate the opportunity provided in responding to your letter to clarify an issue that, as your letter reflects, may be giving rise to misperceptions. In your letter, you argue that Part 359 of the FDIC's regulations (12 C.F.R. Part 359) does not prohibit a bank's insurance policy from covering civil money penalties (CMPs) against institution-affiliated parties (IAPs). Your contention flows from your conclusion that Part 359 does not apply unless the insured depository institution itself makes the prohibited indemnification payment or pays for insurance that covers CMPs or judgments obtained by the federal banking agency. As a result, you argue that where the insurance is procured by the institution and provides for reimbursement for IAPs for CMPs or judgments obtained by federal banking agency, but the IAPs pay for this portion of the coverage, there is no prohibited indemnification payment. For the reasons explained below, your interpretation of Part 359 is incorrect.

Part 359 embodies an important public policy designed to ensure that CMPs obtained by bank regulatory agencies against IAPs will serve as a deterrent to conduct that is inimical to the safe and sound operation of insured institutions. This was made clear when Part 359 was adopted in 1996. In the Preamble, the FDIC stated that one of the purposes of Part 359 is "making sure that [IAPs] are held accountable for substantive violations of law or regulation." 61 Fed. Reg. 5926, 5929 (February 15, 1996). This purpose would not be served by allowing insured depository institutions to purchase CMP coverage for IAPs through "endorsements" to the institution's insurance policy (regardless of whether the institution is reimbursed for the designated cost of the "endorsement"). As a result, Part 359 makes clear that insured institutions cannot act to protect their IAPs from the potential consequences of individual conduct that gives rise to a CMP against that individual.

Part 359 does so, in part, by broadly prohibiting an insured institution or holding company from making a "prohibited indemnification payment." *See* 12 C.F.R. § 359.3. The term "prohibited indemnification payment" is defined as follows:

> The term *prohibited indemnification payment* means any payment (or any agreement or arrangement to make any payment) by any insured depository institution or an affiliated depository institution holding company for the benefit of any person who is or was an IAP of such insured depository institution or holding company, to pay or reimburse such person for any civil money penalty or judgment resulting from any administrative or civil action instituted by any federal banking agency, or any other liability or legal expense with regard to any administrative proceeding or civil action instituted by any federal banking agency which results in a final order or settlement pursuant to which such person:
>
> (i) Is assessed a civil money penalty;
> (ii) Is removed from office or prohibited from participating in the conduct of the affairs of the insured depository institution; or
> (iii) Is required to cease and desist from or take any affirmative action described in section 8(b) of the Act with respect to such institution.

12 C.F.R. § 359.1(l)(1). *See also* 12 U.S.C. § 1828(k)(5).

The focus on payments by the insured institution in this definition is understandable given the overall context of Part 359 and its focus on golden parachute payments and indemnification payments. Part 359.1(l)(2) does recognize that insurance may be appropriate to cover legal fees and related expenses as well as restitution payments for losses to the insured institution. Such coverage principally protects the insured institution from the financial consequences of wrongful conduct by its IAPs and, consequently, is consistent with well-settled public policy. However, Part 359 plainly prohibits the insured institution from making "any agreement or arrangement to make any payment" to reimburse the IAP for a CMP.

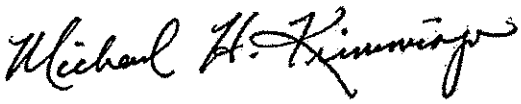
As a result, it is clear that Part 359 prohibits both a direct payment as well "any agreement or arrangement" to pay or reimburse an IAP for the cost of CMPs obtained by the federal banking agency. 12 C.F.R. § 359.1(l)(1). Nothing in Part 359.1(l)(2) can be read to the contrary. In fact, it underscores the overall focus of Part 359 on ensuring that IAPs will owe their fealty and expertise to the insured institution and will not be protected from the consequences of their actions that may be contrary to that responsibility.

Given this public policy, and the terms of Part 359, the fact that the portion of the premium of an insurance policy procured by the insured institution that is attributable to an "endorsement" protecting IAPs from CMPs is paid by the IAP does not make it permissible. The CMP "endorsement" is part of the insurance policy purchased by the insured institution. The contracting parties to this policy are the insurance company and the insured institution. Thus, the party procuring the insurance policy – including the CMP "endorsement" – is the insured depository institution.

Under Part 359, an insured institution simply cannot purchase an insurance policy with CMP coverage for IAPs. No exception exists under Part 359 for cases in which the insured institution purchases an impermissible insurance policy but then collects reimbursement from the IAP for some portion of the institution's insurance premiums.

For the reasons explained above, it is my view that your interpretation of Part 359 is in error. An insured depository institution or holding company cannot purchase CMP coverage for IAPs under Part 359, even if the IAP offers to reimburse the depository institution for the designated cost of a CMP "endorsement."

Sincerely,



Michael H. Krimminger

General Counsel
Federal Deposit Insurance Corporation