

# *Insurance Management*

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## **Introduction**

Insurance is a risk management tool. Although FHLBanks also use some forms of insurance to mitigate credit risk, insurance as described here is primarily used to mitigate operational risk. The potential for liability to an FHLBank arising from its operations and its system of controls should be reflected in its annual risk assessment (Annual Risk Assessment) required to be conducted pursuant to Section 917.3 of the Finance Board regulations.

The value of insurance lies in the protection it affords an FHLBank or persons associated with it from losses arising from failures in the FHLBank's system of risk controls or from other causes. The specific insurance needs of the FHLBank must be assessed on a case-by-case basis; only by reviewing each policy in force can the actual degree of coverage and protection be determined. In addition, insurance management should be reflected in the FHLBank's business continuity operations as the potential for losses and errors may increase due to a disabling event.

The objective of an FHLBank's insurance management process should be to minimize losses and costs arising from risks undertaken by the institution, such as direct costs of loss prevention measures, insurance premiums, losses sustained, and related administrative expenses. The FHLBank's board of directors must determine the maximum loss the institution is willing to accept and should, at minimum, perform and document an annual review of FHLBank's risk and insurance management program for its adequacy. However, the maintenance by an FHLBank of adequate insurance should not, by itself, be viewed as a satisfactory substitute for the other elements of a sound risk management program. Examples of available insurance coverages are described below.

## **Specific Types of Insurance Coverage**

The insurance industry offers various types of coverages that can be purchased which include, but are not limited to, the following:

- 1) ***Fidelity Bond Coverage*** is designed to protect an institution from catastrophic losses resulting from dishonest or fraudulent acts of directors, officers, employees, agents and unrelated third-parties, which include losses arising from:
  - a) Defalcations;
  - b) Use of forged documents;
  - c) Circulation of false securities;
  - d) Circulation of counterfeit money; and
  - e) Other criminal acts.

Customarily, a fidelity bond will contain a ***termination clause*** that should be reviewed by FHLBank personnel responsible for the administration of the insurance management program and/or by legal counsel to ascertain the circumstances under which the bond's coverage may be terminated by its underwriter. For example, the

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bond may provide that its coverage terminates as to any FHLBank employee immediately upon the FHLBank's learning, or any of its officers or directors learning, of the commission by such employee of any *dishonest act* at any time, irrespective of whether such employee is in the employment of the institution, the act is of the type covered under the bond, or the act is committed against the institution.

- 2) ***Directors and Officers (D&O) Liability Insurance*** provides coverage for the indemnification of directors, officers, and other employees against legal and other expenses incurred in defending lawsuits brought against them by reason of the performance of their official duties. Such insurance does not cover instances of crime or dishonesty, personal gain, or apparent conflicts of interest.

Levels of coverage include the following:

- a) Side A-reimburses officers and directors to the extent that they are not indemnified by the company;
  - b) Side B-reimburses a company for amounts spent to indemnify directors and officers for costs, settlements and judgments, subject to a deductible or "retention"; and
  - c) Side C-indemnifies a company against its own liability in connection with securities claims, subject to deductible or retention.
- 3) ***Banker's Professional Liability Insurance (Errors and Omissions Insurance)*** provides coverage to a company against loss from a customer's claim of negligent acts, errors or omissions in the performance of professional services. This may include loss of client data, software or system failure, and failure to perform professional duties.

Customarily, a financial institution will maintain an error and omissions liability policy to provide protection to it from losses arising from negligent acts, errors and omissions committed by it in the provision of services to its customers. An errors and omissions liability policy protects the financial institution and its directors, officers, and employees from loss in instances where there is a written agreement between the institution and its customer to provide professional services to the customer for a fee, or other monetary consideration, or where a fee or other monetary consideration would usually be received, but for business or other reasons, the fee has been waived.

In addition to maintaining an error and omissions liability policy to protect it from its own acts of negligence, errors and omissions in the provision of services to its own customers, an FHLBank should require that third-party vendors with whom it contracts for services maintain adequate coverage under their own error and omissions liability policy and fidelity bonds to protect the FHLBank against loss in the event of negligent acts, errors and omissions on the part of the third-party vendor in providing services to the FHLBank. An FHLBank should perform a close review of the vendor's policy coverages, exclusions, and limitations prior to entering into any agreement with the vendor to provide any service to the institution. For example,

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coverage may not be provided for information technology consultants and contractors who perform services on behalf of the financial institution. Therefore, during the consultant/vendor selection process, an FHLBank should require the consultant/vendor to provide a full analysis of the coverages, exclusions and limitations contained in its errors and omissions insurance policy and fidelity bond.

- 4) ***Commercial General Liability Insurance*** provides coverage for bodily injury occurring on an institution's premises.
- 5) ***Property Insurance*** provides coverage for the theft or destruction of an institution's property and fixed assets such as computer hardware, software, and other office furnishings and equipment, up to a specified amount. Policy coverage should include "hot sites" critical to the maintenance of business continuity.

A close evaluation of the manner in which the insurance agent/broker is notified to adjust policy coverage should be performed by FHLBank personnel responsible for the administration of the insurance management program to ensure adequacy of coverage for newly purchased or leased items. A purchased or leased item will only be insured within the general limits of a property insurance policy unless it has been placed on a specific schedule within the policy that provides for extra insurance coverage above the general policy limits for that item. For example:

- a) Furniture and owned equipment are usually not specifically scheduled with an insurer, so any claim for items lost, stolen or damaged would be based on the general policy limits.
  - b) Leased equipment is usually required by the lessor to be specifically scheduled with an insurer. If new equipment is leased, the insurer is notified of the new schedule and dollar amount, endorses the additional schedule on the certificate of insurance to the lessor and sends the lessor a new certificate of insurance as required by the equipment lease.
- 6) ***Valuable Papers and Records Insurance*** provides coverage for the replacement of valuable papers, and records, including those generated by electronic media.
  - 7) ***Automobile Public Liability and Property Damage Insurance*** indemnifies an institution against property and liability losses arising from injury or death when a bank-owned, leased, or rented vehicle is involved. Non-ownership liability insurance should be considered if FHLBank officers or employees use their own vehicles for business purposes.
  - 8) ***Travel Accident Insurance*** provides coverage to directors, officers, and employees on losses sustained as a result of accidental injury or death while traveling on FHLBank business.

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- 9) ***Umbrella Liability Insurance*** provides excess coverage over and above existing liability policies as well as basic coverage for most known risks not covered by existing liability insurance.
- 10) ***Internet Liability Insurance*** provides coverage against claims that the content and/or performance of an institution's website have adversely affected a customer's business.
- 11) ***Computer Cyber Crime Insurance*** is specialized coverage that is tailored to the specific needs of the institution, including the technology that is being used and the level of risk of cyber crime involved. Traditional insurance policies such as standard property and commercial general liability may not adequately address the risks of cyber-attack or network security failure.

Both first- and third- party coverages can be obtained which include:

- a) Loss/corruption of data, which covers the destruction of information due to viruses, worms, Trojan horses, and the like;
- b) Business interruptions, which result in loss of income as a result of an attack on the institution's network that limits its ability to conduct business; and
- c) Liability costs such as defense costs, settlement costs, and punitive damages that may be incurred by the institution as a result of:
  - (1) Breach of privacy due to theft of data;
  - (2) Transmission of computer viruses, worms, Trojan horses, and the like, which causes financial loss to third parties; and
  - (3) Failure of security, which causes network systems to be unavailable to third-parties.

12) ***Employment Practices Liability Insurance*** provides coverage against claims alleging an employment practices violation arising from wrongful dismissal, discharge or termination, harassment, discrimination, employment-related misrepresentation, libel, slander, defamation or wrongful discipline.

13) ***Employee Benefit Plan Fiduciary Liability Insurance*** provides coverage for specific wrongful acts as respects to a fiduciary or as an administrator of the specified employee benefit plans.

14) ***Terrorism Insurance*** is specialized coverage for losses incurred due to terrorist acts.

15) ***Kidnapping, Ransom and Extortion Insurance*** is specialized coverage for executives that travel extensively. The coverage includes international support crisis management, dedicated phone lines, and professionals who will try to resolve or diffuse incidents or situations with the least harm to the kidnapped.

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### **Regulatory Environment**

The primary rules, regulations and guidance governing insurance and risk management are set forth below:

- 1) ***Rules and Regulations of the Federal Housing Finance Board***, which include parts and sections relevant to insurance management:

Part 917 of the Finance Board rules and regulations addresses powers and responsibilities of the FHLBank boards or directors and senior management. In particular, Section 917.3, Risk Management, and Section 917.6, Internal Control System, are pertinent.

- 2) ***Advisory Bulletins of the Federal Housing Finance Board*** that provide supervisory guidance relating to the topic of insurance management activities are the following:

Advisory Bulletin 03-02, dated February 10, 2003, and Advisory Bulletin 02-3, dated February 13, 2002, which offer guidance on specific attributes to be considered by FHLBanks in the formulation of their business continuity plans and the establishment of bilateral agreements with other FHLBanks.

Advisory Bulletin 05-05, dated May 18, 2005, which provides guidance on the risk management responsibilities of the board of directors, senior management and risk management function.

### **FHLBank Environment**

Within the FHLBanks, the responsibility for the management of the insurance program may differ, as it may be assigned to the facilities management, administrative services, accounting, human resources and/or the legal services functions. Elements of effective insurance management include the following:

- 1) Coordination of the FHLBank's insurance management program among the institution's key/critical operations such as accounting, credit, collateral, cash management, executive department, funds transfers, investments, community investment services, human resources, safekeeping, document custody operations, financial management, information technology, legal services, and the like so that the risks presented by each area of operation are adequately addressed in the institution's insurance coverages.
- 2) Continuing communication with the FHLBank's insurance agent/broker. This includes reviewing with such agent/broker periodic surveys and documentation of trends, new issues/developments and claims histories involving the institution. The insurance broker should review changes in an FHLBank's building plans and major equipment installations. In addition, the FHLBank should review with its insurance agent/broker risk exposure changes that occur between insurance review periods.

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- 3) Existence of sound understanding on the part of FHLBank management of changes in the insurance market and available coverages. Independent insurance agents/brokers receive commissions and are therefore financially interested in the sale of insurance policies to the institution. Consequently, they may not provide fully objective advice to an FHLBank regarding insurance needs. An FHLBank should consider engaging an independent insurance consultant to provide a “second opinion” as to the adequacy of the institution’s insurance coverages which can be considered by the FHLBank in assessing the desirability of modifications to and enhancements of its insurance program.
- 4) Documentation and presentation of the annual review of the FHLBank’s insurance management program to an appropriate FHLBank management committee for its views as to the adequacy of insurance coverage. Thereafter, the insurance program should be presented to the institution’s executive management and the board of directors for review and approval.

### **Risks Associated with Insurance Management**

The primary risks arising in connection with an FHLBank’s insurance management program include the following:

- 1) ***Lack of Sound Corporate Governance (Board of Directors and Senior Management Oversight)***
  - a) Key risks and controls are not adequately identified, assessed, and monitored.
  - b) Information technology is not aligned with the FHLBank’s goals and strategies.
  - c) Responsibility for the operation of the insurance management program has not been assigned.
  - d) Assigned personnel do not have sufficient knowledge and technical expertise to manage the insurance management program.
  - e) An assessment of the adequacy of the insurance management program (including specific coverages, exclusions, limitations, current trends/developments) and costs is not communicated to executive management and the board of directors.
  - f) Background criminal and credit investigations, are not performed on personnel prior to their retention. Periodic credit investigations are not performed and mandatory leave policies have not been established.
  - g) Duties, responsibilities, and liabilities are not adequately addressed with vendors.
  - h) The institution’s business continuity plan does not address the availability of insurance coverages in the event of a disruption in the institution’s business.
  - i) Internal control weaknesses potentially affecting financial reporting have not been adequately identified, assessed and disclosed.
  - j) Independent audit coverage and testing is limited; auditors are inexperienced or lack the technical expertise to test the control environment.

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### **2) *Operational Risk***

- a) Inadequate coordination with the insurance agent/broker on trends, new issues/developments, claims histories, and current coverages affecting the FHLBank.
- b) Lack of a periodic assessment to determine the adequacy of the FHLBank's insurance coverages, taking into account accompanying exclusions, limitations, and costs.
- c) Inadequate coordination by the FHLBank's insurance management function with the other key operating areas of the institution as to insurance coverages and accompanying exclusions, limitations, and notification requirements.
- d) Failure to adequately address duties, responsibilities, and liabilities with vendors;
- e) Failure of the business continuity plan to address insurance considerations.
- f) Lack of compliance with internal controls, policies, procedures, and specific requirements of the insurance policies, resulting in rejection of claims by insurers and incurrence of losses by the FHLBank.

### **Specific Risk Controls Relating to Insurance Management**

An FHLBank's controls relating to the insurance management program are set forth below:

#### **1) Corporate Governance**

The board of directors and senior management have the ultimate responsibility for the design, implementation, and monitoring of the FHLBank's risk management and internal control environment, including the management of operational risk.

Insurance management is utilized as a risk management tool to mitigate the FHLBank's operational risk. Specific attributes include risk identification and analysis, risk control and risk treatment (retaining or transferring the risk). The board of directors and senior management must determine the maximum loss the FHLBank is able and willing to assume and perform an annual review of the FHLBank's risk management and insurance program.

#### **2) Business Continuity**

The potential for liability to an FHLBank arising from defects in its business continuity operations and systems of control should be reflected in the FHLBank's annual risk assessment. Written procedures for operations at its designated hot-site should be developed. For example, back-up tapes should be stored off-site and be easily retrievable. Bilateral relationships with one or more FHLBanks may need to be used to effectuate the FHLBank's activities. Each FHLBank must have at least one back-up system and must test it periodically to ascertain its reliability.

The business continuity plan should address the availability of insurance in the event

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of a disruption in the institution's business. The potential for losses and errors may increase due to a disabling event. For example, due to a disabling event, personnel may have to process wire transfer transactions in a manual environment, thereby increasing the possibility for losses due to errors and fraud.

The FHLBank may mitigate its risks and liability with the purchase of specific insurance and bond coverage such as director's and officer's liability, errors and omissions, data reconstruction, and fidelity bond coverage. Where an FHLBank mitigates its operational risk through the maintenance of insurance coverage, the adequacy of such coverage relative to actual loss experience should be periodically assessed.

In addition, the specific limitations, exclusions, notifications, and other clauses of each policy should be reviewed to determine their effects upon the availability of coverage under specific circumstances. Claims may be rejected if the FHLBank has weak controls or fails to follow its internal procedures.

### **Examination Guidance**

A work program for Insurance Management accompanies this narrative. What follows below are illustrative examples of attributes that should be considered by the examiner in completing the analyses required in that work program. In determining the extent of review and testing to be conducted in completing each analysis, the examiner should take into account his or her assessment of the quality and effectiveness of corporate governance, risk management, internal controls and audit coverage relating to the institution's insurance management activities. Examiners should also be aware of and consider how significant issues or findings identified in other work programs could affect the sufficiency of insurance coverage.

#### ***1) Organizational structure***

- a) Functional organization and reporting structure;
- b) Identification of key personnel;
- c) Primary duties, responsibilities and technical expertise of personnel;
- d) Segregation of duties;
- e) Cross-training of personnel;
- f) Coordination with other departments such as risk management, information technology, treasury and cash management, audit, accounting, credit, collateral, custody, funds transfer, financial management, legal services, and human resources; and
- g) Significant changes in the foregoing since the last examination.

#### ***2) Establishment of risk tolerances and the development of key policies and oversight by the board of directors. Evaluate the adequacy of senior management oversight and the risk management function for insurance management activities, which may include the following:***



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- a) Acquiring types and amounts of coverage adequate for the FHLBank's needs;
  - b) Establishing an annual review of the insurance policies and applicable endorsements or riders that should be conducted by management and the board of directors to determine the adequacy of the institution's coverage when compared to the institution's perceived risks and its system of internal controls. Specific attributes to evaluate include, but are not limited to, the following:
    - (1) Representations in the insurance application;
    - (2) Declarations and insuring clauses.
    - (3) Conditions precedent to coverage;
    - (4) Exclusions;
    - (5) Single loss liability, aggregate limit of liability and deductible amount;
    - (6) Discovery and notification requirements; circumstances under which the fidelity bond coverage may be cancelled, and termination of coverage as to any employee; and
    - (7) Timely notice to the insurance company on legal proceedings against the FHLBank.
  - c) Establishing periodic independent reviews by audit and/or independent expert to assure adequate coverage levels, reasonable premiums, and acceptable terms; and
  - d) Designating specific personnel who are responsible for filing potential insurance claims and coordinating with senior management and legal counsel, and provide for reporting to the board of directors.
- 3) ***Key FHLBank policies and procedures, which may include those relating to the following:***
- a) Risk management;
  - b) Information security;
  - c) Fraud prevention;
  - d) Whistleblower provisions of SARBOX;
  - e) Background and credit investigations;
  - f) Business conduct and ethics;
  - g) Business continuity and recovery; and
  - h) Insurance management.
- 4) ***Risk assessment under Part 917 and internal control evaluation under SARBOX***
- a) Evaluate the effectiveness of the annual risk assessment under Part 917 that identifies the key risks arising from and controls established by the institution; and
  - b) Evaluate the effectiveness of evaluations conducted pursuant to SARBOX that identify the key risks and controls pertaining to financial reporting and evaluate

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potential fraud, and procedures implemented to periodically attest to the adequacy of the control environment.

### **5) *Testing performed by external and internal auditors and outside consultants***

- a) Evaluate the adequacy of the scope, review, and testing performed by external and internal auditors; and
- b) Evaluate the adequacy of the scope, review, and testing performed by outside consultants.

### **6) *Identification and evaluation of controls and significant changes to the activity or function***

- a) Evaluate the workflow, analyses, and processes, as well as controls, including the level and direction of risk and the quality of risk management. Examples of specific attributes include, but are not limited to, the following:
  - (1) Designation of employee(s) responsible for the management of the insurance management program;
  - (2) Ongoing communication and coordination with FHLBank's insurance agent/broker that includes the review and consideration of periodic surveys and documentation of trends, new issues/developments, claims histories, and changes in building and equipment installations involving the institution, as well as independent reviews of the adequacy of the institution's insurance coverages by its insurance agent/broker or consultant;
  - (3) Existence of a sound understanding on the part of FHLBank management (achieved either through FHLBank staff expertise or through the use of an independent insurance consultant) of changes in the insurance market and available coverage without undue reliance upon the FHLBank's insurance agent/broker;
  - (4) Coordination with and communication of key aspects of the insurance program, including coverages, exclusions, limitations, notification requirements, outstanding litigation and potential claims, to the principal operational areas of the FHLBank;
  - (5) Establishment of procedures and requirements governing the use of outside consultants/vendors and service providers such as agreements, evidence of fidelity bonds and errors and omissions liability insurance policies;
  - (6) Satisfaction of insurance requirements that relate to FHLBank's business continuity plans and hot-site; and

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- (7) Coordination with FHLBank's human resource director or his or her designee with respect to employee-related disciplinary issues which may impact the fidelity bond coverage; and periodic reporting to and review of the insurance management program with senior/line management and the board of directors.
- b) Evaluate any significant changes that have been implemented and/or are under consideration with respect to the insurance management program, including systems, processes, and staffing that may affect the control environment.

### **7) *Testing***

Conduct testing as appropriate. The scope of testing should be based on the preliminary review of governance, risk management, internal controls and audit coverage. Specific examples include, but are not limited to, the following:

- a) Determine whether revisions and/or adjustments to the insurance program should be considered based on recent surveys, trends/new developments and claims histories involving the FHLBank that have been received from its insurance agent/broker and/or an independent, third party review.
- b) Determine whether there are any recommendations that should be made to enhance the insurance management program, based on the documentation of the most recent insurance review.
- c) Evaluate the adequacy of insurance coverage by reviewing the FHLBank's current insurance policies, together with accompanying riders and endorsements. Examples of attributes to be reviewed include, but are not limited to, the following:
  - (1) Representations made in the insurance application;
  - (2) Declarations and insuring clauses;
  - (3) Conditions precedent to coverage;
  - (4) Exclusions such as the untimely notification to the insurance company, failure to perform criminal background and credit investigations on new employees, or inadequate corrective action with respect to employee once fraudulent act has been identified;
  - (5) Single loss liability, aggregate limit of liability and deductible amount;
  - (6) Discovery and notification requirements, circumstances under which the fidelity bond coverage may be cancelled by the underwriter and termination of coverage as to any employee; and
  - (7) Timely notice to the insurance company on legal proceedings against the FHLBank such as fidelity bond, D&O liability policy and errors and omissions liability policy claims.
- d) Verify that the status of key attributes of the insurance program, such as specific coverages, exclusions, limitations, notification requirements, costs, comments

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- from the FHLBank's insurance agent/broker and assessments contained in any independent insurance review, existence of outstanding litigation and potential claims, have been communicated to the appropriate management committee of the FHLBank.
- e) Verify that the status of key attributes of the insurance management program have been reported annually to senior management and the board of directors.
  - f) Obtain personnel files for newly- hired, -transferred and -terminated employees, as well as employees subject to disciplinary action, and perform the following procedures:
    - (1) Select a sample of personnel files of new employees and verify that the appropriate criminal and credit investigations were performed prior to the employee's retention;
    - (2) Select a sample of files on current employees in high-risk positions and verify compliance with the FHLBank's anti-fraud policies; and
    - (3) Review and evaluate disciplinary action taken with respect to the employees and determine if the circumstances giving to the actions potentially affect the fidelity bond coverage of the FHLBank and whether timely corrective action was undertaken by the institution.
  - g) Evaluate whether requirements under the FHLBank's insurance policies have been addressed in the FHLBank's business continuity plan. Determine if any conditions precedent to coverage may not be satisfied due to a disabling event, such as operating in a manual environment and being unable to record customer transaction requests, verify customer authorizations, or perform callbacks.

### **8) *Assessment of Risks***

Summarize the results of the activity or function examined in a separate memorandum. The memorandum must articulate the risks and the management of those risks. It should also clearly and specifically describe the basis and analysis for the assessment. The memorandum should discuss the type(s) of risk (market, credit, operational); the level of risk (low, moderate, high); the direction of the risk (stable, decreasing, increasing); and the quality of risk management (strong, adequate, weak). A memorandum must be prepared irrespective of whether the examiner's assessment is positive or negative.

### **9) *Items requiring follow-up at the next on-site visitation***

Identify key issues that have been communicated to management (written or oral) that require follow-up during the next on-site visitation.