Comptroller of the Currency
Administrator of National Banks

Washington, D.C.

Bank Failure

An Evaluation of the Factors Contributing to the Failure of National Banks

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Office of the Comptroller of the Currency
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June 1988

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Dear Bank Managers and Directors,

Since the beginning of the 1980s, OCC examiners have gained considerable practical experience in dealing with banks that run into problems and, in some cases, ultimately fail.

In order to take full advantage of that experience, and to gain a better understanding of why banks fail, the OCC undertook a detailed study of selected national banks during the last decade. We looked at three groups of banks: those that failed, similarly situated banks that experienced problems but were restored to health, and banks whose condition never deteriorated, despite problems in their local economies.

The results were clear. In most cases, specific factors and patterns of practices within a bank itself ultimately determined its success or failure, although economic problems in the market served by that bank often played a contributing role.

We began this study to help bank examiners identify potential problem areas in banks that otherwise appear to be healthy. But the results are so clear that we believe they will be equally useful to bank managers and directors. I urge you to read this report and its appendices. What you learn about specific management problems and systems may help you strengthen your bank and assure its ultimate success in a period of increasing competition and economic uncertainty.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

NOTE

This booklet was prepared under the general direction of Robert J. Herrmann, Senior Deputy Comptroller of the Currency. Important guidance was provided by Kevin M. Blakely, Deputy Comptroller for Special Supervision, and Susan F. Krause, Deputy Comptroller for Economic Analysis and Strategic Planning.

The project was headed by James E. Horner and Fred C. Graham. Oversight and analysis were provided by Roger W. Burns, David L. Grainger, Bruce E. Ludwick, and Kennard L. Page.

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TABLE OF CONTENTS

INTRODUCTION

In the 1980s, more banks have failed than in the entire previous post-Depression period. These failures have coincided with a period of serious economic decline in certain sectors, most notably agriculture, oil and gas, and commercial real estate. A common presumption is, therefore, that these bank failures have been caused by adverse economic conditions. This presumption is believed to be further borne out by the fact that most failed banks have been located in regions with troubled economies.

This view, though seemingly plausible, is in conflict with the Office of the Comptroller of the Currency's long-held belief that a bank's management and board of directors bear the ultimate responsibility for the performance of their institutions. While the OCC recognizes that the economy plays an important role, examiners also have noted that many banks successfully weather periods of adverse economic conditions.

To understand more clearly the relative roles of external economic difficulties and internal management factors in determining a bank's success or failure, the OCC undertook a study to identify and evaluate the factors contributing to the failure of national banks. The OCC believed that isolating such factors would help it identify banks likely to fail and strengthen its ability to supervise and to help prevent other banks from failing. The study showed that while poor economic conditions make it more difficult for a bank to steer a profitable course, the policies and procedures of a bank's management and board of directors have the greater influence on whether a bank will succeed or fail. In other words, poor management and other internal problems are the common denominator of failed and problem banks.

Management-driven weaknesses played a significant role in the decline of 90 percent of the failed and problem banks the OCC evaluated. Many of the difficulties the banks experienced resulted from inadequate loan policies, problem loan identification systems, and systems to ensure compliance with internal policies and banking law. In other cases, directors' or management's overly aggressive behavior resulted in imprudent lending practices and excessive loan growth that forced the banks to rely on volatile liabilities and to maintain inadequate liquid assets.

Insider abuse and fraud were significant factors in the decline of more than one-third of the failed and problem banks the OCC evaluated. Much of that insider abuse or fraud involved directors, senior management, or principal shareholders or was related to their failure to provide adequate oversight and controls.

Economic decline contributed to the difficulties of many of the failed and problem banks. It was, in fact, a significant cause of problems in more than one-third of the banks we evaluated. Rarely, however, were economic factors the sole cause of a bank's decline. All but 7 percent of the failed and problem banks also had significant internal problems related to management.

This paper presents the findings of our study. It identifies the specific internal weaknesses that appear to be most influential on a bank's failure. It also assesses the primary factors that seem to distinguish banks that fail from those that do not, even in troubled economic environments. The study provides evidence that management and the board of directors, ultimately, are responsible for the success or failure of a bank. It highlights the need for a bank to establish strong policies, controls, and systems when economic conditions are good, thereby greatly increasing its chances of remaining profitable when economic conditions are bad.

DESCRIPTION OF THE STUDY

The OCC's study is based on an analysis of banks that failed, became problems and recovered, or remained healthy during the period 1979 through 1987. The OCC analyzed 171 failed banks to identify characteristics and conditions present when the banks deteriorated.[1] The OCC also evaluated a sample of 51 rehabilitated banks in similar circumstances that experienced significant difficulties from which they recovered. These rehabilitated banks' composite CAMEL ratings moved from a 1 or a 2, to a 4 or a 5, and then returned to a 1 or a 2, during the 1979 through 1987 period.[2] The OCC evaluated these banks to identify characteristics and conditions present when they became problem banks, and again to identify the characteristics and conditions present when they returned to health. Finally, the OCC evaluated a sample of 38 healthy banks that maintained composite CAMEL ratings of 1 or 2 throughout the period. The healthy banks served as a control group against which the OCC compared the groups that experienced problems.

The OCC collected two types of data. First, examiners recorded factual information about each bank's geographical location, asset size, type of ownership, and changes in control. Second, we subjectively evaluated each bank's performance in eight broad categories. The categories were:

1. Policy, planning, and management quality;
2. Audits, controls, and systems;
3. Asset quality;

[1]The sample includes 94 percent of the banks that, between 1979 and 1987, were declared insolvent by the OCC and on which one of the following actions was taken by the FDIC: a purchase and assumption, a deposit transfer, or a payoff of insured depositors. The 6 percent not included were banks for which sufficient information was not available at the time of the review.

[2]The acronym CAMEL represents the five categories in which banks are rated by examiners—**C**apital, **A**sset quality, **M**anagement, **E**arnings, and **L**iquidity. The composite rating represents the overall status of the bank and takes into account the ratings in all five categories. A 1-rated bank is in the best of health while a 5-rated bank is very near failure. A bank with a composite rating of 4 or 5 is labeled a problem bank by the OCC.

4. Liquidity and funds management;
5. Nonfunding expenses;
6. Insider abuse;
7. Fraud; and
8. Economic environment.

Using examination reports, bank histories prepared by OCC examiners, and other information provided by banks and examiners, the OCC determined the extent to which each rehabilitated and failed bank's performance in a particular category caused it to have problems or to fail. Within each of the eight categories, the OCC evaluated a number of specific characteristics to determine whether each was significantly present, marginally present, or not present. By evaluating these factors, it was possible to detail the particular difficulties and strengths that banks had within each of the broader categories.

Most of the failed banks were smaller banks located in the OCC's Midwestern, Southwestern, and Western districts; that is, 78 percent had less than $50 million in assets. The rehabilitated banks and healthy banks were chosen to conform as closely as possible to the failed banks in terms of location, problems in the economy, and asset size.

WHY BANKS DEVELOP PROBLEMS

The major cause of decline for problem banks continues to be poor asset quality that eventually erodes a bank's capital. The OCC's intent, however, was to determine the factors that were commonly responsible for the poor asset quality. In particular, the OCC wanted to determine the relative importance of internal factors—the banks' management practices—and external factors—the economic environment. To that end, examiners and analysts evaluated the internal and external conditions faced by the three groups of banks in the study.

Internal Problems

Board and Management

The study showed that deficiencies within boards of directors and management were the primary internal problems of problem and failed banks. The quality of a bank's board and management depends on the experience, capability, judgment, and integrity of its directors and senior officers. Several management shortcomings and the problems related to them are discussed below.

(1) Uninformed or Inattentive Board of Directors or Management

The OCC's recently released publication, *The Director's Book*, emphasizes the importance of a bank's board of directors. Specifically,

> "A bank's board of directors is ultimately responsible for the conduct of the bank's affairs. The board controls the bank's direction and determines how the bank will go about its business. . . . A board must be strong, independent, and actively involved in the bank's affairs. The long-term health of the institution depends on it."

Nearly 60 percent of failed banks had directorates that either lacked necessary banking knowledge or were uninformed or passive in their supervision of the bank's affairs. Such deficiencies often arose when the board was not getting sufficient or timely information from management and was not making enough of an effort to correct problems. More than half of the rehabilitated banks had similar deficiencies during their decline into problem bank status. In contrast, none of the boards of the continuously healthy banks or of the rehabilitated banks upon their return to health had deficiencies in these areas.

It is important to distinguish the role and responsibilities of boards of directors from those of management. The responsibilities of the board in directing the bank are:

- to ensure competent management;
- to ensure that appropriate plans and policies are in place;
- to monitor operations ensuring adequate internal controls and compliance with applicable laws and regulations;
- to oversee business performance; and
- to ensure that the bank serves the credit needs of its community.

To fulfill these responsibilities the board should maintain clear lines of authority and accountability and ensure that management understands and carries out the bank's policies. Although the board should leave day-to-day operations (managing the bank) to management, it must retain overall control.

The study showed the following factors, related to poor board or management supervision, to be significant problems for many of the failed banks:

- Nonexistent or poorly followed loan policies (81 percent of the failed banks);
- Inadequate systems to ensure compliance with internal policies or banking laws (69 percent);
- Inadequate controls or supervision of key bank officers or departments (63 percent);
- Inadequate problem loan identification systems (59 percent);
- Decisions made by one dominant individual—*e.g.*, CEO, chairman, or principal shareholder (57 percent); and
- Nonexistent or poorly followed asset and liability management policies (49 percent).

These deficiencies clearly indicate a need for improved oversight on the part of the board of directors and managers. Failure to address problems like these may, in part, be the result of the inability of the board and management to understand important changes in the deregulated financial environment, *e.g.*, risk and return issues as compared to costs of funds.

In general, the study found that rehabilitated banks had similar problems during their decline. Yet, they had somewhat fewer problems with regard to inadequate board supervision of key officers and controls to ensure compliance with policies and laws.

Problem and failed banks consistently lacked policies, systems, and controls to guide their staffs in performing the tasks required to maintain a well-managed and income-producing loan portfolio through both good and bad economic times.

Healthy banks were not immune to some of the characteristics connected with problem or failed banks, although healthy banks never exhibited these factors to the same extent as problem and failed banks. The most frequently identified characteristics related to one dominant decision maker and inadequate systems to ensure compliance with internal policies and banking laws.

(2) Overly Aggressive Activity by Board or Management

Another set of problems that prevailed in failed banks was overly aggressive activity, described as excessively growth-minded or following liberal credit views. Aggressive, growth-minded behavior is not, in and of itself, a weakness. In fact, an aggressive approach combined with well-established policies and controls can be a successful strategy. What the OCC found to be a problem, however, was *overly* aggressive or *excessively* growth-minded actions relative to the circumstances in which the bank operated. In 42 percent of the failed banks, the board of directors was aggressive in a way that had a significantly negative effect on performance.[3] In fact, eight of every 10 failed banks were judged to have had a board or management that was overly aggressive to some degree. The lending and operating practices of many of these banks also reflected problems. For example, failed banks frequently exhibited:

- Inappropriate lending policies: liberal repayment terms, collection practices, or credit standards (found in 86 percent of the failed banks);

[3]Note that an aggressive board can also be an uninformed or inattentive board. It can emphasize growth and aggressive income generating policies without monitoring or even knowing the particular activities of its management.

- Excessive loan growth in relation to the abilities of management staff, control systems, or funding sources (51 percent);
- Undue reliance on volatile liabilities—*e.g.*, deposits greater than $100 thousand, but not necessarily brokered (41 percent); and
- Inadequate liquid assets as a second source of liquidity (38 percent).

During their decline, the rehabilitated banks also experienced problems associated with overly aggressive behavior, but less frequently than the failed banks did. Only 22 percent had a board that examiners judged to be significantly overly aggressive, and fewer than 50 percent tended to be overly aggressive to any degree. Moreover, declining rehabilitated banks had fewer significant problems with excessive loan growth, reliance on volatile liabilities, and inadequate liquid assets. In spite of their more conservative behavior relative to that of the failed banks, 96 percent of the rehabilitated banks still had some form of inappropriate lending practices during their decline. The problems associated with liberal lending practices were apparently less detrimental when accompanied by a less aggressive lending philosophy.

Among the healthy banks, overly aggressive behavior was nearly nonexistent. Rehabilitated banks, after their return to health, also had no significant problem with any of the characteristics we have associated with overly aggressive behavior. This evidence shows that overly aggressive behavior may well underlie severe problems and make recovery from those problems much less likely.

(3) Problems Involving the Chief Executive Officer (CEO)

The CEO is probably the most important determinant of the success or failure of a bank. The study's results indicate how important the CEO is by showing that CEOs had significant weaknesses at many of the problem banks. Sixty-three percent of the failed banks had CEOs that clearly lacked the capability, experience, or integrity necessary to make their banks successful. Another 18 percent had CEOs who showed some signs of weakness in these areas. In the declining rehabilitated banks, CEO problems were less often significant; still, 39 percent had significant problems, and another 39 percent had marginal shortcomings.

The CEOs at the healthy banks were generally judged to be strong. Those at continuously healthy banks had no apparent problems with experience, capability, or integrity. Likewise, those at recovered banks had no significant problems in these areas. Clearly, choosing a strong CEO is an important step in ensuring a bank's success.

(4) Other Problems Related to Oversight or Management Deficiencies

Other indications of either overly aggressive activity or uninformed management decisions included:

- Excessive credit exceptions—*i.e.*, missing financial statements or income information about borrowers or poor collateral documentation/perfection (found in 81 percent of the failed banks);
- Overlending—*i.e.*, high loan amount relative to debt service ability of the borrower (73 percent);
- Collateral-based lending and insufficient cash flow analysis (55 percent); and
- Unwarranted concentrations of credit to one industry (37 percent).

We found these factors, in nearly identical percentages, in the rehabilitated banks during their decline.

Surprisingly, excessive credit exceptions were found in a high percentage of healthy banks, especially in those that were continuously healthy. This behavior was apparently not as damaging when other lending practices are well-conceived and executed.

Insider Abuse and Fraud

The study found insider abuse in many of the failed and rehabilitated banks during their decline. Insider abuse—*e.g.*, self-dealing, undue dependence on the bank for income or services by a board member or shareholder, inappropriate transactions with affilitates, or unauthorized transactions by management officials—was a significant factor leading to failure in 35 percent of the failed banks. About a quarter of the banks with significant insider abuse also had significant problems involving material fraud. Material fraud, in fact, played a significant role in 11 percent of the failures. During their decline, 24 percent of the rehabilitated banks experienced significant insider abuse, but none were seriously affected by material fraud.

Healthy banks, in contrast, generally avoided problems in these areas. Those that had recovered from problem bank status had corrected even their marginally apparent insider abuse and fraud problems. Of the continuously healthy banks, one had a marginal problem with fraud and another with insider abuse.

problems of insider abuse and fraud were often related to the lack of oversight and controls. Several conditions, found more often in failed banks that experienced significant insider abuse and fraud than in failed banks that did not, may have provided the opportunity for such problems to become significant. Inadequate supervision of key officers, a dominant decision maker, unwarranted concentrations of credit to one industry, out-of-area lending, and inadequate guidelines for purchasing loan participations all appeared as significant conditions substantially more often in the failed banks with significant insider abuse or fraud than in other failed banks.

Generally, these conditions, with the exception of a bank's reliance on one dominant decision maker, were at worst marginally apparent at the healthy banks. About one in four of the continuously healthy banks had marginally unwarranted concentrations of credit to one industry, but fewer than 10 percent of the healthy or recovered banks had any of the other characteristics mentioned above. Apparently, proper supervision of bank officers and formal guidelines to monitor and control lending practices also helped to limit insider abuse and fraud.

External Factors—The Economic Environment

Seventy-three percent of the failed banks operated in significantly depressed economic conditions, while another 15 percent faced marginally depressed conditions. These depressed conditions usually resulted from the deterioration in the agricultural, oil and gas, or commercial real estate economies. Simply operating in depressed local economies does not, however, imply that a bank's failure is largely the result of the economic conditions. The study did show that an adverse economy was a significant factor in 35 percent of the failures. Even so, a depressed economic environment was the sole significant cause of failure in only 7 percent of the banks surveyed. The remaining failed banks that operated in depressed economies had significant internal problems as well.

The evidence from healthy and rehabilitated banks also supports our hypothesis that economic conditions are rarely the primary factor in determining a bank's condition. Fifty-nine percent of the rehabilitated banks and half of the healthy banks operated in significantly depressed economies. In fact, the study showed that economic conditions played a significant role in the decline of a larger percentage (39 percent) of the rehabilitated banks than of the failed banks. While many of the rehabilitated banks were assisted in their recovery by improving economic conditions, they also made the necessary managerial changes to promote recovery. Sixteen percent of the rehabilitated banks recovered in spite of operating in local economies that remained significantly depressed. Another 67 percent faced marginally depressed economic conditions during their recovery. Without the improvements in management, controls, and systems, these banks would have been far less likely to benefit from improvements in their economies.

WHY SOME BANKS RECOVER WHILE OTHERS FAIL

A number of factors may contribute to a problem bank's recovery. These include:

- changes in management,
- improved banking practices;
- changes in banking philosophy;
- capitalization; and
- improved local economic conditions.

In spite of the few lingering problems found at rehabilitated banks, their efforts to make important changes were clear. At the directorate level, changes in knowledge, involvement, and philosophy were evident. The OCC judged the boards of nine of every 10 recovered banks to be very active in overseeing the operations of their institutions. Although rehabilitated banks were not the victims of overly aggressive boards to the extent that failed banks were, all of those that did have this problem made appropriate adjustments. Furthermore, when the OCC's evaluation revealed a CEO who lacked ability or integrity, 90 percent of the rehabilitated banks replaced the CEO, while 76 percent of the failed banks did so.

The fact that rehabilitated banks, during their decline, were less likely to have an overly aggressive board of directors or to follow practices that might be deemed overly aggressive also worked in their favor. The study showed that overly aggressive behavior—undue emphasis on growth—is apparently a very risky strategy, largely because it leaves the bank exposed when the economy turns against it. If the growth takes place in a sector that is experiencing a speculative boom, for example, a downturn can be sudden and severe. Overly aggressive lending under such conditions may underlie a more rapid erosion of a bank's net worth and make recovery less likely.

Another important factor is that, relative to failed banks, rehabilitated banks had a much better record of compliance or partial compliance with administrative actions (*e.g.*, a memorandum of understanding, a formal agreement, a cease and desist order) taken by the OCC. The OCC took administrative actions in roughly similar percentages with the failed and rehabilitated banks. OCC examiners, however, judged rehabilitated banks to be in compliance or partial compliance with administrative actions that were in place at the time of bank examinations 86 percent of the time. They judged failed banks to be in compliance or partial compliance only 41 percent of the time.

The failure to comply with these regulatory actions does not simply mean that a bank was unable to change its financial situation. Rather, such failures imply that the banks did not make a serious or competent effort to meet the directives contained in the administrative action. Generally, even failed efforts are considered to be partial compliance ("meeting the spirit" of the action), and isolated exceptions to the letter of the action do not necessarily result in a judgment of unacceptable compliance.

Another factor that obviously affected a bank's ability to recover from difficulties was its capitalization. Capital serves as a buffer between operating losses and insolvency. The more capital a bank has, the more losses it can withstand. In other words, a bank's capitalization determines the amount of time it has to correct internal weaknesses or to outlast negative external influences. Whether a problem bank fails or recovers will often depend on the time it has before its losses completely dissipate its capital.

The OCC found that investors injected an average of $950 thousand in new capital per rehabilitated bank but only an average of $300 thousand per failed bank. Although the larger injections of capital into the rehabilitated banks may simply reflect the investors' "deep pockets" or their perception that these banks offered a better investment opportunity (*i.e.*, they were prospectively viable), they undoubtedly bought more time for the banks to complete their recoveries.

While a banker's job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times. Management and the board of directors must act positively to implement such controls and systems if they intend to safeguard the shareholders' capital over the long run. The evidence in the study shows that attention to and compliance with administrative actions taken by bank supervisory agencies have a positive impact on a bank's condition. •

WHY SOME BANKS STAY HEALTHY

The 38 healthy banks in the OCC sample were not free of managerial shortcomings or externally generated economic problems. As mentioned above, we chose the healthy banks so that 50 percent of them faced a significantly depressed economic environment. The OCC's analysis shows that these banks generally had fewer internal difficulties than the banks in the other groups. In fact, none of the healthy banks that operated in depressed economies had significant problems in any of the other broad categories previously mentioned. Moreover, only six had significant difficulties in more than three of the numerous specific, underlying areas of concern. This evidence, along with that from the failed and rehabilitated banks, confirms the OCC's belief that the best way for banks to weather an economic storm is to minimize internal shortcomings. A strongly managed bank with adequate systems that are in place and followed is best prepared to remain profitable through both good and bad economic times.

The healthy banks had many fewer managerial problems than the banks in the other groups. Without exception, examiners judged board supervision and general management behavior from the CEO down to have posed no significant problem for these banks. Rather, the CEO and other officers in the healthy banks showed significant strengths in their diverse backgrounds and experience in banking matters.

Officer and staff positions below the CEO level also appeared to have had an impact on a bank's success. The study noted a much higher level of overall management diversity and experience in healthy banks than in problem banks. Further, an assessment of the adequacy of officers and staff (number, tenure, turnover) showed healthy banks to be in a much better position than failed or problem banks; 92 percent of the healthy banks received very high marks for this characteristic compared to only 15 percent of failed banks. These statistics highlight the importance of capable, consistent support staff below the senior management level.

None of the healthy banks in the OCC sample experienced any significant insider abuse or fraud.

Although the healthy banks were not completely without weaknesses, their weaknesses were generally isolated and offset by strengths in other areas. The way to maintain a bank's health, therefore, appears to be to limit the number of shortcomings of management, the board of directors, and the policies and systems they put in place.

CONCLUSION

The study identified, through the evaluation of failed, rehabilitated, and healthy banks, the difficulties and conditions that result in problem and failed banks. Examiners and analysts focused on the relative importance of external economic factors and internal managerial factors. The study found that internal factors can have a great influence on the extent to which an adverse external environment harms the bank. The OCC sample includes banks that failed in reasonably good, as well as in bad, economic environments. It also includes banks that recovered from problems, and others that remained healthy in bad economic environments. The difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management. Banks succeeded by establishing and adhering to policies that would see them through both good and bad economic times. While the managements of these banks were not without problems, they tended to have problems in fewer areas, rather than difficulties in all areas as did most of the failed banks.

To get a better idea of how the healthy banks remained healthy in spite of poor economic environments, the OCC interviewed several of the banks' chief executive officers and board chairmen. The bankers who were interviewed each played an active role in overseeing a successful bank in an economically depressed region. Their comments support the results of the OCC's evaluation.

Without exception, they emphasized the importance of an active and involved board of directors. They said the board and management should work together within well-specified roles to establish realistic goals and a strategic plan for the bank. In other areas, the interviews revealed that these bankers generally had a well-conceived banking philosophy. They had formal, written policies in place. They kept lending limits low for all bank officers from the CEO down. They established clear rules for documentation, collateral, and other lending procedures, and compliance was monitored through well-established review processes. Perhaps most important, given the troubled economic regions in which they operated, these bankers emphasized profitability and conservative lending, even at the expense of growth. Each of the bankers interviewed pointed to the overly aggressive pursuit of growth, especially among recently established banks, as a major weakness in the troubled banks in their areas.

The opinions of these bankers, supported by the success of their banks, and the study's conclusions, supported by the OCC's analysis, clearly point to management shortcomings and inadequate board supervision as the critical cause of bank failure.

Some might argue that the same internal weaknesses exist in many viable banks that operate in very healthy local economies, and they, undoubtedly, would be correct. But that is not really the issue. Banks are not in a position to exercise any great influence on the external conditions they face. They are, however, in a position to change their internal operating procedures. One thing is certain: external conditions will continue to fluctuate. The OCC study demonstrates that banks are able to remain healthy institutions throughout the fluctuations by establishing and maintaining strong internal policies, systems, and controls. Without such policies they are more likely to succumb to the external fluctuations. Problem and failed banks are almost never simply the result of depressed economic conditions. In the evolving business of banking, successful bankers must understand the risks of the businesses in which they are engaged, ensure the expertise of their board and management, and establish the operating capability to handle the products and services they offer.

APPENDICES

Descriptive Characteristics of the Surveyed Banks

Banks by Asset Size:

	Percent of		
Asset Size in $	Failed Banks	Rehabilitated Banks	Healthy Banks
0–15 million	30	16	13
16–30 million	34	41	26
31–50 million	15	14	24
51–100 million	12	17	29
100MM–1 billion	8	12	8
Over 1 billion	1	0	0

Bank Location by OCC District:

	Percent of		
OCC District	Failed Banks	Rehabilitated Banks	Healthy Banks
Northeastern	3	2	0
Southeastern	4	2	0
Central	8	16	18
Midwestern	15	37	24
Southwestern	52	35	45
Western	18	8	13

Banks Operating in Depressed Local Economies

	Percent of Banks in Significantly Depressed Economies			
	Failed Banks	Rehabilitated Banks		Healthy Banks
		Before recovery	After recovery	
Operated under depressed economic conditions	73	59	16*	50
Agricultural	22	41	8	3
Mixed agricultural and oil and gas	15	4	0	5
Mixed agriculture and commercial real estate	0	0	2	0
Oil and gas	15	4	5	16
Mixed oil and gas and commercial real estate	3	2	0	11
Commercial real estate	14	2	2	16
Other	4	6	0	0

*Another 67 percent of the rehabilitated banks operated in marginally depressed local economies after their recovery.

Eight Broad Categories Where Weaknesses Had A Significant Impact on Decline

Categories	Percent of Banks with Significant Weaknesses	
	Failed Banks	Rehabilitated Banks (Before recovery)
Policies, planning, and management	90	88
Audits, controls, and systems	25	24
Asset quality	98	98
Liquidity and funds management	10	6
Nonfunding expenses	9	4
Insider abuse	35	24
Material fraud	11	0
Economic environment	35	39

Corrections of Management-Driven Weaknesses Were Important in the Recovery of the Rehabilitated Banks

Characteristic	Rehabilitated Banks					
	Declining Condition			Improving Condition		
	No	Moderately True	Yes	No	Moderately True	Yes
Poor judgement in decision process	14%	28%	50%	88%	12%	0%
Inadequate management, officers, or staff	22%	29%	41%	67%	31%	0%
Inadequate controls of key officers or departments	31%	24%	41%	94%	6%	0%
Inadequate or failed to follow loan policy	4%	16%	80%	65%	35%	0%
Inadequate problem loan identification system	2%	16%	82%	65%	31%	4%
Excessive growth relative to management, staff, controls, systems, funding	61%	18%	22%	100%	0%	0%

Problem and Failed Banks
Lacked Important Management-Driven Strengths

Strong Policies, Controls, and Systems

Condition	Significant Positive Condition			
	Improving Banks	Healthy Banks	Failed Banks	Declining Banks
Systems to ensure compliance with policies and law	67%	45%	6%	10%
Loan policy	65%	50%	4%	4%
Controls over key bank officers or departments	94%	87%	16%	31%
Problem loan identification system	65%	58%	9%	2%
Management information systems	77%	71%	18%	26%

Loan Portfolio Management Practices are Important Determinants of Asset Quality

Characteristic Present	Healthy Banks			Failed Banks		
	No	Moderately True	Yes	No	Moderately True	Yes
Liberal lending practices	84%	13%	0%	2%	10%	85%
Excessive growth relative to management, staff, systems, funding	84%	13%	3%	24%	22%	52%
Overlending	79%	11%	0%	5%	12%	73%
Collateral-based lending	60%	32%	3%	8%	27%	55%
Unwarranted Concentrations of Credit	76%	24%	0%	34%	22%	37%
Out-of-area lending	88%	5%	3%	41%	15%	23%
Excessive financial statement exceptions	37%	34%	29%	3%	16%	79%
Excessive collateral documentation exceptions	52%	39%	0%	5%	22%	67%

Distinguishing Features of Failed and Problem Banks with (and Without)* Insider Abuse and/or Fraud

Specific Condition	Percent of Banks with Significant Problems	
	Failed Banks	Rehabilitated Banks (Before recovery)
Decisions made by one dominant individual	74 (46)	67 (46)
Management behavior negatively affected an affiliate relationship	31 (6)	25 (3)
CEO of poor integrity	70 (21)	58 (8)
Inadequate supervision of key officers	79 (52)	58 (36)
Out-of-area lending	39 (4)	42 (8)
Inadequate guidelines for purchasing loan participations	31 (12)	8 (8)
Unwarranted concentrations of credit	49 (28)	17 (26)

*The number without parentheses is the percentage of banks with insider abuse or fraud that also had the particular characteristic. The number in parentheses is the percentage of banks without significant insider abuse or fraud problems that had the particular characteristic.

Administrative Actions with Problem Banks

Action Taken (*)	Rehabilitated Banks	Failed Banks
Memorandum of Understanding	12%	14%
Formal Agreement	47%	46%
Cease and Desist Order	69%	75%

*Percentages do not add to 100 because more than one action may have been taken against a particular institution.

Degree of Compliance with Administrative Actions

Compliance	Rehabilitated Banks	Failed Banks
Acceptable	45%	6%
Partially Acceptable	41%	35%
Unacceptable	14%	59%

Appendix B—GLOSSARY OF TERMS

Summarized below are definitions of many of the terms/characteristics used in this paper. For each sample bank, scores were assigned to reflect the relative degree of presence or absence of these conditions.

Board of Director and Senior Management Characteristics

Board Lacks Necessary Banking Knowledge: Board members who fail to understand their responsibility to set policy and institute ways to measure management's performance. Directors who lack business experience or do not understand general banking procedures. For example, board members have a poor understanding of various areas such as funds management, proper documentation for the types of loans being made, or proper control systems. The board may have approved or ignored situations or transactions which a knowledgeable director could be expected to question.

Board Uninformed of Bank's Operation/Passive Board: These are two distinct concepts, but are scored together because the effects are the same. An uninformed board may not receive good reports on which to base decisions. This could be a lack of reports or too many detailed reports hindering the ability to see trends or the larger picture. An uninformed board may be shielded from needed information by management. A passive board tends to be dominated by management or one or two members. While they may or may not be well informed, they defer to the leadership of management or a particular member without much dissent. Passive boards tend not to question or are easily convinced that a particular situation or transaction is normal, legal, or desirable.

Overly Aggressive Board: A board that sets growth or income as a prime goal to the detriment of asset quality standards or funding sources. A board may be aggressive by being liberal in credit views although they may also be passive, uninformed, or lack banking knowledge. An overly aggressive board seeks growth or profits without first properly ensuring that stable funding is available or that credit standards and controls are in place to minimize undue risk.

Decision-Making Process Lacks Proper MIS: Board/management does not have appropriate reporting systems to identify key trends, problems, asset quality, etc. Board/management reports may exist but may be inaccurate, lack key information, or be too detail oriented.

Poor Judgment in Decision-Making Process: This data element is intended to reflect instances where the board has simply made bad decisions in key areas which are not the apparent result of divided loyalties. A high rating for this element would ordinarily reflect a board and management that had reasonable access to information upon which to act but ignored that data or for other reasons made poor choices.

Decisions Made by One Dominant Individual: A bank where one person is clearly dominant with little room for opposing opinions or discussion. Often this person also holds a large block of stock. The individual may be unable to delegate and may be involved in too many routine decisions to see the larger picture or may be too strong willed to recognize errors or risks in his/her decisions. This element is not always negative, however. A dominant individual could be a very good manager. This element scores the existence of a dominant person, not its effect.

CEO Lacks Experience/Capability: New CEO, untested, with limited or overly specialized experience as opposed to executive management experience in a bank environment. A CEO whose ability, judgment, training, or personality limits his capability to perform effectively as an executive officer of a bank. An example could be a CEO who just cannot say "no" or one who does not understand fundamental credit analysis.

CEO of Poor Integrity: A CEO who has divided loyalty or who has engaged in self-dealing or fraud. A CEO who places his personal financial dealings before the bank's. A CEO who may have lied to the board or examiners or who has difficulty in recognizing unethical conduct.

Management Team: Lack of Diversity and Breadth of Experience: (Qualitative assessment) A management team with limited training or experience for the types of business conducted. A management team that is less than fully competent for the situation. For example a management team could have many years' experience but it may be all in the same bank using out-dated methods. A quality management team must be able to evolve, to keep up with a changing industry, etc.

Inexperienced/Inadequate Management/Officer/Staff Other than CEO: (Quantitative assessment: number, tenure/turnover, etc.) Simply trying to do too much with too few people. A bank with high turnover in key areas. A small bank with only two officers trying to do the work of three or more.

Inadequate Controls/Supervision of Key Officers/Departments: Poor control or supervision of key areas. The CEO or board has failed to properly evaluate or review the work of certain areas. For example, a senior loan officer may be essentially unsupervised due to tenure and the trust placed in that officer by the board. This individual may initiate a large number of poor quality transactions before anyone is aware of the risks the officer is taking. Another example could be an investment officer who commits the bank to a large volume of inappropriate investments without management and the board consciously approving that strategy.

Inadequate Policies or Failure to Follow Policies (Loan; Investment, Asset/Liability Management [or funding], Concentrations [of assets]; Conflict of Interest): A bank which does not have such policies; where such policies are inadequate to guide officers in the types of business the bank was involved in; or where the board fails to require compliance with all or part of the policy. An example of this could be a bank where the board has adopted policies in all of these areas but where the policies are kept in the board minutes only. The policies are not actually used by officers to guide their decisions, and the board rarely, if ever, actually reviews or tests compliance with the policies. Thus, the board may have gone through the perfunctory exercise of adopting policies, possibly only to placate regulators.

Audits, Controls, and Systems

Inadequate Controls/Systems to Ensure Compliance with Policies and Law: Where a bank fails to have a system of checks and balances to ensure officers or employees operate within board policy and that transactions comply with law.

Inadequate Problem Loan Identification System: The board and management should be continuously aware of those loans which have deteriorated, need additional documentation, or have higher than normal risk. This should be accomplished by some form of internal loan review which identifies and reports such loans for board and executive review and action. A bank with no problem loan list or one that does not adequately measure risk or trends in the portfolio would have an inadequate problem loan identification system.

Excessive Financial Statement Exceptions: A large number or dollar amount of loans which are not supported by current financial information on primary obligors or guarantors appropriate for the type of loan. Management should have sufficient information to make an informed credit decision regardless of the type of credit. In general, if exceptions total more than 7 percent to 10 percent of total loans, this item would be scored. However, a critical score would generally indicate more than 10 percent exceptions (15% to 20% or more) or significant exceptions in key loan departments or types of loans. Credit exceptions include such things as lack of a current balance sheet, income statement, or a cash-flow analysis for loans to be repaid from operations of the business.

Poor Collateral Documentation/Perfection: Significant overall level of collateral exceptions or significant exceptions in a particular type of loan. Collateral exceptions include failure to record liens, improperly filed liens, failure to inspect collateral, failure to perform lien search, failure to obtain loss payee clause on appropriate insurance, failure to obtain reliable appraisals, failure to control collateral, etc. Scoring for this data element is not as closely tied to percentages of the portfolio as financial statement exceptions.

Liberal Terms/Failure to Enforce Repayment (Inadequate collateral/capitalized interest): Where a bank makes loans with repayment terms that are indeterminate, bear no relation to the purpose of the loan (*i.e.*, 10 year loan on equipment with expected life of five years), or are otherwise more liberal than would be expected for a given loan type. Failure to enforce repayment can include simply allowing customers to ignore payment terms. It can also include loans where payments are extended or the loans renewed frequently without requiring significant paydown, particularly if interest is added to the new loan from the old loan. Liberal terms, the failure to recognize problem situations, and postponing recognition of problems through renewals may result in the board's having a false sense of security. This could lead the board to take actions which would not be prudent if the true condition of the bank's loan portfolio were known.

Excessive Loan Growth in Relation to Management/Staff Abilities, Controls/Systems, Funding Sources, etc: In order for a bank to increase loans successfully, it must have a sufficient number of skilled officers and employees to handle the work load created by making the loans and also by monitoring and servicing the loans thereafter. The bank must also have sufficient funds (deposits, borrowings, or capital) to make loans. Losses can occur through narrowed or negative interest spreads if the bank's loan growth is funded by incurring a large amount of interest-rate risk (to add to the credit risk of the new loans) through borrowings or high cost, volatile deposits. Liquidity problems can also develop if available funding sources contract.

Out-of-Area Lending: If a bank makes loans to borrowers who are not in its normal trade area, the bank's ability to properly evaluate the loan and to monitor and service it is diminished. A normal trade area is the area where the bank makes most of its loans and receives most of its deposits, and in which it has a good understanding of the economics and practices. Many banks routinely have a few out-of-area loans to former area residents or affiliates of local businesses, etc. Where a borrower resides or conducts business is not the main issue. The key is whether or not the bank knows the customer and whether the bank can monitor the credit.

Overlending: High Loans to Debt Service Ability: Often occurs in tandem with liberal terms/renewals. Loans based on no or inadequate analysis of the borrower's actual capacity to pay. For example, making loans to a particular farmer because he has a large number of highly productive acres rather than actually determining if he can service the additional debt. Overlending includes character lending. Such loans are based on officer or board personal friendships or long-time associations with a customer, his good standing in the community, or reputation rather than the customer's ability to pay. It is assumed he can pay because he's a good farmer or a good person, or has always paid before. A large net worth or equity in a business or farm does not necessarily mean a customer has the cash flow to make required payments.

Collateral-Based Lending/Insufficient Cash-Flow Analysis: This item scores the bank's reliance on collateral values (or assumed collateral values) rather than ability to pay. This practice is often believed to be safe and conservative because the bank always has collateral. However, without an analysis of the customer's ability to pay, the bank is in a sense volunteering to buy the collateral. The collateral may decline substantially in value (*e.g.*, oil prices, farm land values), or the bank may fail to obtain a reliable appraisal of the collateral. When the bank does take the collateral, it often turns out to be worth less than the loan or is illiquid. This is particularly true if the collateral is specialized in nature.

Inadequate Loan Participation Purchased Guidelines? Although stated as a policy issue, the scoring of this item also reflects practice and procedures. Loans purchased (participations) from another institution may be out-of-area and are originated by another bank. The other bank usually retains the responsibility to service the loan. Thus, the buying bank often has little actual control over the credit and is usually not part of the initial negotiation of terms or evaluation of the loan proposal. Since the buying bank is exposed to more risk than on the direct loans it makes, such loans should be evaluated, documented, and monitored at least as well as direct loans made by the bank. A high rating for this element indicates a bank which has accepted poorly documented, high risk, poorly structured, poorly monitored, or out of area loans, without doing a good job of evaluating the credit on their own before buying, or without monitoring the purchased loans thereafter.

Unwarranted Concentration of Credit: A concentration of credit is a high volume of assets with very similar risk characteristics. A concentration is generally defined as more than 25 percent of total capital. Examples of concentrations are loans to one industry; loans to one group of companies or affiliated businesses; loans secured by the same type of collateral (soybeans, oil production); or out of area loans. Concentrations have a high level of risk for the bank because they amount to having all of the bank's eggs in one basket. For example, if oil prices go down, suddenly all oil production loans could be in trouble. It is normal for many community banks to have high concentrations related to local economic bases. For example, banks in rural areas will have a large portion of assets invested in farm loans and farm-economy dependent businesses. An *unwarranted* concentration is where the bank allows a concentration that it does not have to permit (*e.g.*, making loans to one group of affiliated companies or loans dependent upon the price of one commodity) rather than ensuring good diversity.

Asset/Liability Management

Reliance on Volatile Liabilities ($100M and greater certificates of deposit, not necessarily brokered): This element scores the extent to which a bank has relied on this volatile funding source to support assets; is related to failure to develop sufficient core deposits, but is different in that it focuses on the substitute for core deposits; considers the strategy of funding through the most volatile deposits. This type of funding may be used to support growth or replace other funding contractions, such as a decline in core deposits, which creates undesirable mismatches in maturities and interest-rate sensitivity.

Inadequate Liquid Assets/2nd Source of Liquidity: This element scores the bank's ability to convert assets to cash without sizable capital losses or to borrow sufficient sums to meet its needs. Such needs can include funding asset commitments, paying matured or withdrawn borrowings, or funding deposit contractions. A bank's primary sources of liquidity after cash equivalents are the investment portfolio and borrowings. If the market value of the bank's investments is below book value, the bank would realize a loss on the sale of such assets. Similarly, because of a bank's reputation or financial condition, lenders may not be willing to lend money to the bank. It is important to note that for this study, the data elements are scored based on the bank's initial liquidity problems. As problem banks become critical and fail, liquidity problems often become much more severe. Liquidity at failure is not scored here.

Insider Abuse

The term, "insider" refers to principal shareholders, directors, executive officers, and other officers or staff who, through their position, are able to influence operations or decisions within a bank. Insider abuse is a general term that encompasses various activities which may or may not be lawful. While an abusive situation usually violates one or more banking laws or regulations, legal violations are not a necessary element. Insider abuse includes the broader range of actions where an insider takes action or fails to take action; where the bank is harmed, takes on additional risk, or loses an opportunity; and where the insider or a related party somehow benefits because of the insider position.

Self-Dealing: This is a term used to encompass those situations in which an insider's interest is placed above the interests of the bank or where insiders use their position or authority to grant loans or conduct other transactions for personal benefit or the benefit of relatives or related business interests. This can encompass many types of situations. One of the most common forms of self-dealing involves making loans to oneself and related businesses at preferential terms and/or with lowered underwriting standards for the purpose of making a profit in the side business.

It is not necessary that the person actually process the paperwork involved in such transactions; more important, the transactions must occur on the authority of insiders. Self-dealing can describe a single bank executive authorizing transactions for himself or various officers and directors approving transactions for each other. Self-dealing situations usually violate one or more regulations or statutes, but the term is sufficiently broad as to include situations where the transactions may be technically lawful but exhibit bad judgement or self-interest above the interests of the bank.

Board/SH (principal shareholders) Dependence on Bank for Income/Services: This element is similar to self-dealing in that directors and shareholders may have a number of transactions with the bank. However, when such transactions are handled at arms length with the full knowledge of disinterested directors, present no unusual additional risk to the bank, and are lawful, they are usually not considered self-dealing. This element is intended to score those situations where directors and shareholders may not be considered to be self-dealing but they become dependent upon the bank for income and services. This may occur through overlending or adverse trends in the interested party's business. For example, a director may start out as one of the bank's best customers, but, for whatever reason, reaches a point where he is dependent upon the bank for services and thus may no longer be able to make objective decisions as a director. He may develop divided loyalty or be much less willing to take action on other problem bank assets lest his own transactions be similarly treated.

Inappropriate Transactions with Affiliates: Affiliates are businesses or relationships which, due to common ownership, directors, or influence, are tied closely to the bank. This element scores the extent to which unlawful or detrimental transactions have occurred with affiliates.

Unauthorized Transactions by Management Officials: This data element scores transactions in which a manager has executed transactions for his or a related interest's benefit without full knowledge and authority from the board. It also may involve transactions which do not benefit the manager directly, but were not within the manager's authority or were done without board knowledge of what the manager was doing. For example, sometimes bank management disagrees with a board decision or is afraid to inform the board of a particular situation. An officer then acts on his own.

Fraud

Material Fraud: This element is intended to score situations where significant fraud has been discovered or is strongly suspected by examiners. Ordinary teller losses, etc., are not scored here. Material fraud generally includes the intent to deceive and/or an attempt to conceal. A high score would be attributed to this element if the fraud was large in relation to the bank's capital or was otherwise a significant factor in the deterioration of the bank.