



## FINANCIAL INSTITUTIONS THAT FAIL: AN INDUSTRY REPORT UPDATE

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Uncertainty continues to hang over Wall Street and Main Street. Size limits on the country's largest financial institutions, statutory leverage ratios, the establishment of the Consumer Financial Protection Agency – all are clear indicators the overall health of the U.S. financial services industry represents a national economic concern.

In 2009, FDIC bank failures numbered 140. Through the first five months of 2010, the number of failures had already totaled nearly 80. Regardless of fiscal position, the population of banks is predicted to steadily decline in the coming years. To help ensure continued organizational viability, both the Board of Directors and senior management should continue to emphasize strategic planning and risk mitigation efforts that are consistent with not only sound overall business practices but also with prevailing regulatory concerns.

Late last year, Jefferson Wells analyzed 31 FDIC Enforcement Orders issued in 11 major markets between January and August 2009. The financial institutions included in the analysis varied in asset size, with a total asset average of approximately \$500 million (the largest institution had total assets of just under \$3 billion). Recently, the 2009 study was updated with additional FDIC data to identify potential new Enforcement

Order trends and other areas of regulatory emphasis.

When compared to the earlier study, the 2010 Jefferson Wells analysis of FDIC Enforcement Orders (issued from September 2009 through February 2010) found the overall monthly average number issued increased from approximately 48 to 62 per month. Cease and Desist Orders continued to be the most prevalent type of Order issued, accounting for more than half (53 percent) of all Orders issued during the sample period. The 2010 study included 29 financial institutions in 12 major

### **Is your organization's liquidity contingency funding plan adequate?**

Have you:

- Established appropriate goals and objectives?
- Identified overall responsibilities, including monitoring and reporting?
- Established red flags to identify a liquidity crisis?
- Documented a risk assessment?
- Performed stress tests?

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## FDIC ENFORCEMENT ORDER COMPARISON

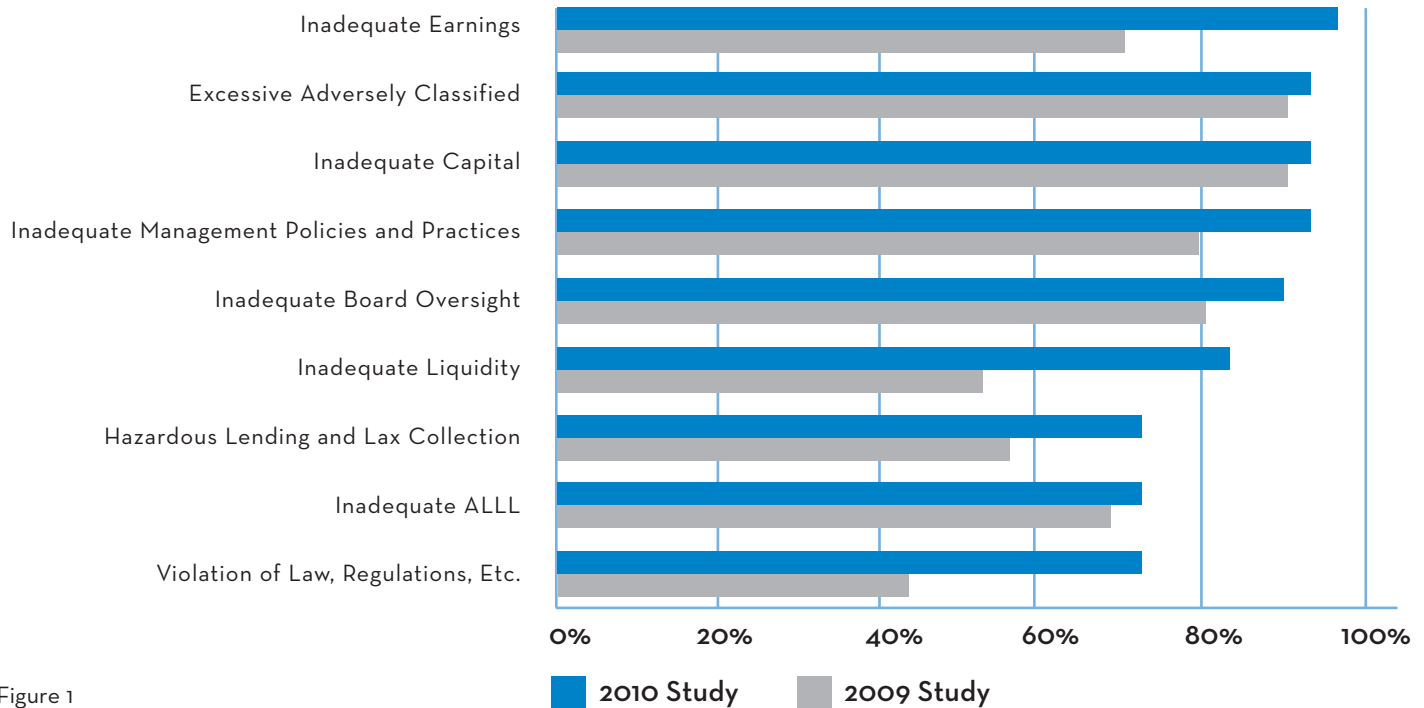


Figure 1

markets, with total asset sizes from \$32 million to more than \$10 billion. The findings from each institution’s FDIC Enforcement Orders were then aggregately compared to the prior study to identify the latest regulatory trends.

### INCREASED EMPHASIS IN THREE AREAS

The 2009 study identified four areas of aggregate regulatory concern: 1) Board governance; 2) treasury management; 3) credit quality; and 4) compliance. While the latest analysis reconfirmed these as critical areas of concern in assessing the overall health of a financial institution, the relative rankings revealed some changes. (The 2010 top regulatory concerns and how they compared to the 2009 study results appear in Figure 1 above.)

When compared with the 2009 results, the 2010 study found only nominal changes to the rate of Enforcement Order citation/occurrence in adversely classified assets, capital, management policies and practices, Board supervision and oversight, and ALLL. More significant study-to-study changes were noted, however, in the following three areas:

#### 1. Imprudent lending and collection practices

Hazardous lending and lax collection practices continue as regulatory concerns. In the 2009 study, this issue was cited in 57 percent of the Enforcement Orders reviewed. In the latest study, the rate of occurrence increased to more than 70 percent.

In addition, two more loan-related insights resulted from the 2010 study. First, regulatory mention of credit concentration issues increased significantly on a study-to-study basis, from being noted in only 30 percent of the 2009 Enforcement Orders reviewed to more than 65 percent of the Orders sampled in the most recent analysis. These study results support the belief of many within the financial services industry that credit concentrations may play a role in the next likely financial services crisis. Secondly, it was noted that inadequate loan policies (including risk rating and loan review processes) also had an increased rate of occurrence – 66 percent of the latest Enforcement Orders sampled (up from 50 percent in 2009).

The relative stability in the rate of occurrence in certain loan-related issues, coupled with the specific

increases described above, suggest that concerns regarding overall credit quality, insufficient loan review processes, and inadequate loss allowances will continue to be common Enforcement Order findings within financial institutions that fail. As noted in the earlier study, comprehensive documentation (including minutes, policies and procedures, and credit files) and regular and independent credit quality evaluations are critically important internal controls.

## **2. Earnings and liquidity**

Inadequate earnings were noted in 70 percent of the 2009 Enforcement Orders reviewed, and liquidity concerns were noted 53 percent of the time. In contrast, the 2010 study revealed an increase in these concerns to 97 percent and 83 percent, respectively. While a number of macro-economic factors (geographic dispersion, entrance and exit of competitors, etc.) can impact earnings, the fact that the financial institutions analyzed in both studies demonstrated internal deficiencies in both Board of Directors oversight and management policies and practices suggests that effective internal processes and controls are the more crucial factors in mitigating the risk of financial institution failure.

Regarding liquidity, the 2010 study results indicate the need for increased management as prescribed by Financial Institutions Letter FIL-13-2010 (April 5, 2010). The letter outlines the processes financial institutions should follow to appropriately identify, measure, monitor and control funding and liquidity risk. Without improved management practices in this area, it's highly likely poorly capitalized firms will remain subject to capital and dividend restrictions.

## **3. Violations of specific laws and regulations**

In the 2009 Jefferson Wells study, compliance management was noted as an integral part of an entitywide risk management approach. While safety and soundness concerns continue to appear frequently in regulatory Enforcement Orders, an increase in the number of citations regarding specific violations of law, rule, regulation, or statement of policy was also observed. Specifically, the rate of occurrence increased from 43 percent in the 2009 study to 72 percent in the 2010 study. To reduce the likelihood of monetary fines and penalties related to regulatory noncompliance, management should continue to

demonstrate a strong commitment to complying with federal laws and regulations.

## **THE KEYS TO PREVENTING FAILURES**

Improving the health and stability of the nation's financial services industry will require a long-term effort. Similarly, improving the internal operations and financial results of a specific financial institution that's on the brink of failure requires a long-term plan.

Rather than implement short-term fixes, both the Board of Directors and management need to ensure appropriate strategic planning is performed and the financial institution's internal controls are sufficient. Specifically, the Board should: 1) ensure it effectively supervises the financial institution's affairs by adopting and adhering to sound organizational policies; 2) understand the institution's financial and overall operating condition; and, perhaps most importantly; 3) select qualified personnel to perform the firm's day-to-day management activities.

Likewise, management must effectively carry out its assigned duties (i.e., planning and policy making) while simultaneously ensuring effective internal control and management information systems have been established. Ultimately, the individual and combined efforts of the Board of Directors and management are the most critical keys to preventing failure.

